FAIR GAME

IS AUSTRALIA VULNERABLE OR GETTING ITS FAIR SHARE?

A systemic approach to evaluating Australia's international tax policy settings, transfer pricing outcomes and related tax issues in corporate financing.

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Chapter 1 Overview 5

Chapter 2 A systemic approach to tax policy to best position Australia 11

How Australia taxes cross-border direct investment by multinationals 11

Special considerations in relation to dividend and interest withholding taxes 16

The "Iceberg Model" and criteria for evaluating the Australia's company tax regime 18

The dynamic nature of systemic analysis and the tax significance of intra-group dealings 24

Understanding the economic value chains of multinational groups and how tax impacts 25

Distinguishing tax drivers from social, economic, technological and environmental drivers 29

The critical relationship between multinational groups and their shareholders 29

Dysfunctional effects of non-alignment of tax policy and the competitive market system 30

The interplay of tax policy settings and competitive forces 30

Ineffectiveness of compartmentalised approaches to major policy issues 31

The frame of reference and methodology for effective tax policy settings 33

Debates about company tax rates and attracting foreign investment capital 35

The responsiveness of foreign investment and GDP to statutory tax rates 36

Shortage of foreign investment or lack of business investment opportunities? 38

Understanding the sources of Australia's competitive advantage 40

Do Australia's tax rules give foreign based multinationals a competitive edge? 41

Distinguishing increases to Australia's capital stock from foreign takeovers and restructures 43

Balancing revenue needs with the use of tax policy for wider social or economic objectives 44

Chapter 3 Law design and compliance management for a viable company tax base 45

Responsibilities and remuneration of group managers can impact risk to Australia's tax base 45

Multinational groups have enormous flexibility in structuring their global operations **46**

Ensuring different parts of Australia's tax laws relevant to corporate financing are coherent **46**

The effectiveness of profit shifting strategies is determined by their economic substance **47**

A strategic approach to law design with feedback loops to ensure ongoing effectiveness **49**

Tax policy no substitute for policy levers directly impacting structural drivers and dynamics **50**

Understanding the structural drivers and dynamics shaping current economic conditions **50**

Chapter 4 Factors driving business investment and how it is structured **51**

Misalignment between liability to Australian tax and economic value created by Australia **55**

Base broadening and base protection allow greater flexibility to adjust company tax rates **57**

Chapter 5 The competitive market system for debt and equity funding **60**

Security, financial covenants, guarantees and other financial assurances **62**

Credit facilities, lines of credit and commitment fees **64**

Factors affecting the group's mix of debt and equity funding **64**

Implications of geographical spread for business risk and exchange rate exposure **69**

Chapter 6 Planning, budgeting, treasury processes and the funding of subsidiaries **71**

Business structures and tax structures **72**

Parental guarantees **73**

Financial strategy and tax issues related to the funding of group subsidiaries **75**

The Chevron Case **80**

The application of Division 13 in the Chevron Case **87**

The application of Subdivision 815-A in the Chevron Case **109**

Chapter 7 A multilateral approach needed to protect Australia's tax base **130**

Chapter 8 Data issues in assessing economic and tax system performance **134**

Chapter 9 Data needed to identify tax risks and their tax system impacts **138**

Chapter 10 Transfer pricing issues in marketing and distribution companies **143**

The competitive market system of marketing and distribution companies **143**

Transfer pricing litigation involving marketing and distribution subsidiaries **148**

Chapter 11 The critical role of the ATO in optimising the company tax base **157**

The ATO's strategic role and what it means for how it administers **157**

How well does the ATO understand the business environment and the tax risks? **158**

Does the ATO understand the performance of the company tax base and the tax gap? **159**

The efficiency, effectiveness and balance of ATO compliance strategies **173**

The effectiveness of ATO relationships with large business **177**

Chapter 12 Conclusions **181**

Appendix 1 Standard and Poor's Corporate Rating Frameworks **186**

Appendix 2 Evidence of Dr Lowe on the economic climate, House of Representatives Standing Committee on Economics, 24 February 2017 **190**

Appendix 3 Evidence of Drs Lowe and Ellis on casualization and underemployment in the Australian workforce, House of Representatives Standing Committee on Economics, 24 February 2017 **192**

Appendix 4 Evidence of Dr Lowe on factors affecting foreign investment, House of Representatives Standing Committee on Economics, 24 February 2017 **194**

Chapter 1: Overview

Complexity seems to be overwhelming traditional policy setting approaches and undermining public policy effectiveness in many areas including: the positioning of Australia in the global economy; the management of the domestic economy; debates about significant tax policy questions; and in major tax litigation. So, how can policymakers, administrators and professions better understand and manage that complexity?

A lot of the difficulty in developing effective responses to current challenges emanates from compartmentalised linear approaches that try to address symptoms of issues which are structural and multidimensional in nature. The difficulty in formulating effective policy responses can emanate from the inherent complexity of the issues; or from the way issues are presented by vested interests in political debates in the hope they become the dominant narrative; or from a single discipline frame of reference and work pressures that can drive a short-term compartmentalised focus. To redress these shortcomings the decision-making process has to encompass all factors (positive and negative) that have an important bearing on whether a current policy position is appropriately aligned to the context in which it has to operate and whether it is capable of achieving its objectives. This requires a broader frame of reference, inter-disciplinary collaboration, and sufficient diversity of views to ensure an objective analysis of what is working, what isn't, and why.

Compartmentalisation and linear approaches can also create anomalies when legislative policy is sought to be applied to the facts and circumstances of a particular case. It can often be seen in the way contesting litigants seek to frame their evidence and arguments to the court. This is particularly evident in transfer pricing cases as will be seen in the discussion of *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation*[1] in Chapter 6, a case involving the debt financing of a group subsidiary, and *Roche Products Pty Ltd v FC of T*[2] and *SNF (Australia) Pty Ltd v FC of T*[3] in Chapter 10, cases involving marketing distribution subsidiaries.

Chapter 2 proposes a systemic analysis framework. Throughout the paper various examples are then used to demonstrate how the framework can be used in relation to big picture issues right down to the application of the law in specific types of cases. The examples include: the positioning of Australia within the global competitive market system; the current performance of the Australian economy; the operation of Australia's company tax regime; and, the application of Australia's transfer pricing rules in the contexts of corporate financing and marketing/distribution companies. It is also applied in evaluating the effectiveness of the ATO's administration of the taxpayer demographic comprising the 1,400 major economic groups. The objective is to show that for each of these levels and contexts the framework enables policymakers, tax administrators and tax professionals to better understand and manage the complexity of issues that are arising.

Chapter 2 begins with an overview of the federal taxes Australia collects. It highlights the relative significance of company tax collections and explains how Australia taxes company

[1] [2015] FCA 1092 and [2017] FCAFC 62 on appeal.
[2] [2008] AATA 639; 2008 ATC 10-036.
[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.

profits arising from cross-border direct investment. It then describes a set of interconnected diagnostic tools comprising the "Iceberg Model", the mapping of the economic value chains of multinational groups, economic functional analysis and productivity analysis. The purpose is to show that the combined application of these tools allows a more meaningful scrutiny of observable facts, transactions and events, using the analogy of the visible part of the iceberg and the unseen structure that is holding the observable section in place. The suggested approach seeks to show that the combined use of these tools allows the negative spaces and gaps to be conceptualised and identified; what is not seen, the missing elements that commercially rational participants and regulators would expect to see or want to create in terms of stocks and flows, competitive advantage, productivity and profitability. The proposed methodology includes a distillation of the patterns and trends in the stocks and flows of transactions and events (and the patterns and trends in relation to the absence of desirable transactions, stocks, flows and events) for deeper analysis of the underlying causes and their impacts. It seeks to demonstrate that the framework provides a way of sufficiently defining problems that then enables appropriate, measurable policy or administrative responses to be shaped. In relation to the use of tax policy settings, identifying the real cause of problem determines whether it is fundamentally a problem that emanates from, or can be addressed in any measurable degree by, the way the company tax provisions are framed and the level at which the statutory rate of company tax is set - or whether some other form of policy response is needed.

Chapter 2 explores whether the economic forces that drive revenue efficiency, cost efficiency and profitability in dealings between independent entities within the competitive market system break down in the highly vertically integrated structures and processes adopted within multinational groups. It considers the motivation that profits are maximised by the group as a whole and what implications this may have in relation to ensuring that arm's length margins are allocated to each stage of their economic value chain. The Chapter explores the impacts that a centrally controlled business model might have on competition between participants in Australia's domestic markets and on Australia's ability to ensure it gets its fair share of revenue on the profits generated through the operations in Australia.

The analysis takes for granted that Australia will need to be responsive to emerging strategic issues on an ongoing basis. However, it explores whether the use of the systemic analysis tools in policymaking and tax administration might allow Australia to complement this responsiveness with a forward-looking approach that makes public policy more effective and sustainable.

Chapter 3 explores the application of the systemic analysis framework to evaluate the effectiveness of the current company tax settings and administrative approaches in achieving revenue collections in line with the economic rewards that multinational groups are obtaining from their Australian operations. It explores the type of legislative design and compliance management processes needed to enhance the sustainability of Australia's tax base in the context of tax competition between countries and the enormous tax structuring flexibility multinational groups have. The Chapter examines whether the different parts of Australia's tax laws fit together properly to form a coherent taxation framework.

The following key drivers of attitudes to tax compliance are explored: the tax attributes of the ultimate shareholders of the multinational group; the way that management performance is evaluated and rewarded; the negative impact that the payment of company tax has on the

profits and profitability of the Australian operations; and, the perceived level of expertise and resourcing of the Australian Taxation Office (ATO) relative to private sector capabilities.

Chapter 4 continues the exploration of the relationship between tax policy settings and how they impact on foreign direct investment. It examines the economic, financial and business factors driving global business investment decisions and how multinational groups would take Australia's company tax regime and other relevant rules into account in making those decisions and in determining how their Australian operations should be structured and financed. It emphasises the importance of not only the statutory rate of company tax, but also the availability of concessions, exemptions and tax offsets that reduce the effective rate of tax, and any scope that business investors judge they may have to avoid tax by exploiting weaknesses or lack of coherence in the Australian tax law or that arises through differences between Australia's tax rules and those of other countries. The Chapter explores possibilities for base broadening and strategic investments in ATO resourcing and capabilities to optimise Australia's tax base, an approach that would provide greater flexibility to adjust company tax rates when required. It also explores the role of tax administration and the use of settlements and penalty provisions in major audits due and their implications for taxpayer behaviour. (See also the discussion of settlements in Chapter 11).

Chapter 5 describes the financial market context that needs to be taken into account when considering tax policy settings that impact on corporate financing. It addresses the distinctive roles and risks that equity and debt funding have in business financing, the different ways in which shareholders and lenders are rewarded and the different tax treatment accorded to profit distributions on the one hand and business leverage, interest expense and bad debts on the other. The Chapter discusses the relationship between the group's capital structure and its weighted average cost of capital (WACC). It discusses the significance of capital structures in relation to a group's WACC and its implications for earnings per share (EPS) and return on equity (ROE). It also explores what competitive advantage or disadvantage and vulnerability may flow from a group's WACC. The Chapter explains how the competitive market system influences a multinational group's tolerance for debt funding and consequently establishes minimum equity funding requirements.

The factors affecting credit ratings are also examined, drawing on the methodologies Standard and Poor's use to rate industrial companies, corporate groups and their subsidiaries (including special considerations relevant to the rating of financial services groups). The Chapter also discusses the considerations taken into account by prospective lenders in making the decision whether or not to lend and in determining the amount they would be prepared to lend. It also discusses the options lenders have to require security, priority, guarantees and financial covenants to better manage the credit risk they assume and how these features can reduce the costs of borrowing. The availability and pricing of financial guarantees are also discussed. The systemic analysis also explores whether it is feasible or desirable to equate the tax treatment of equity and debt.

Chapter 6 complements Chapter 5 (which explores the operation of the competitive market system for debt and equity funding) by examining how multinational groups develop their internal funding strategies to provide budget funding, capital expenditure and liquidity to various parts of the group and the role of the group treasury in pooling surplus funding and managing financial risks on a group wide basis. Chapter 6 explores the implications that this centralised financial management that is designed to optimise the costs and benefits for the group as a whole may have for tax compliance in Australia. The Chapter examines whether

and to what extent the constraints that the competitive market system places on the levels of debt and equity funding a multinational group can carry in order to minimise its cost of capital apply at the group subsidiary level. The Chapter also explores the options that parent companies have in relation to the funding of their Australian subsidiaries and their tax implications. (Options that multinational groups have to ensure the solvency of thinly capitalised or loss-making subsidiaries are discussed in Chapter 8 which deals with data issues relevant to evaluating the company tax regime). Chapter 6 also covers the role of parental guarantees for subsidiaries, exploring the distinction between credit enhancement and cases where the guarantee acts as a substitute for equity funding. It discusses the application of the systemic analysis framework to the facts in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation*[4] and how the Federal Court addressed the application of Australia's transfer pricing rules to the commercial realities of the case.

Chapter 6 identifies Australia's thin capitalisation regime and the associated repeal of the debt creation rules in Division 16F of *Income Tax Assessment Act 1936* as areas for policy reform.

Chapter 7 focusses on need for policymakers, tax administrators and tax professionals to consider tax issues through unilateral, bilateral and multilateral frames of reference. The unilateral basis takes account of issues that arise purely in the domestic context in relation to the coherence and robustness of Australia's company tax regime. The bilateral basis encompasses the historical approach to international relations and the use of treaty shopping and cross-border arrangements between Australia and another country as tax planning devices. The multilateral basis takes account of the growing complexity of global economic value chains and the use in global tax planning of more complex structures involving shopping for treaty and non-treaty countries that confer tax advantages, the use of tax havens, low tax jurisdictions and concessional regimes. The Chapter highlights a number of challenges in relation to corporate financing strategies employed by multinational groups and identifies specific areas for policy reform.

Chapter 8 examines data integrity issues that can prevent systemic analysis or create endogeneity that masks what is really happening. The inherent connections between the macro and micro levels in the Australian economy and the aggregation of micro level data to form the overall picture raise the important question as to how micro level data can be tested for reliability. The Chapter examines the reasons why various data sets are compiled and how they are used within the different statutory and corporate governance reporting obligations and processes. It explores how the reason for the compilation of data and how it is used can assist in evaluating its reliability in terms of systemic analysis and understanding the behavioural drivers, analysing the roles of consolidated group accounts, financial statements and management reporting data.

Chapter 9 builds on Chapter 8 (dealing with data integrity issues) by arguing that for Australia's company tax system to be properly evaluated it is necessary to distinguish between the following three sets of drivers:

(i) economic and business factors affecting the financial results and profile of the group's Australian operations;

[4] [2015] FCA 1092 and [2017] FCAFC 62 on appeal.

(ii) Australia's tax policy settings and their impacts on whether multinationals invest, how the Australian operations are funded, the calculation of their taxable profit and the company tax payable; and
(iii)tax planning and tax avoidance.

The Chapter also explores how data reported by Australian subsidiaries of multinational groups can be evaluated by reference to the economic footprint that the group has in Australia, and explores how such an analysis might assist tax risk assessment. The Chapter examines the reliability of effective tax rates as a measure of tax system performance against the background of the different sets of drivers listed above, exploring the use of the economic footprint in Australia and economic and financial outcomes at the consolidated group level as check points. It argues for the development of an economic model that evaluates the firm level economic and financial performance of the 1,400 major economic groups, can be aggregated to model the impacts of this demographic on economic activity and revenue performance in Australia, can produce a reasonable measure of the responsiveness of real economic activity to major tax policy settings, and supports the analysis of the costs and benefits of tax concessions.

Chapter 10 discusses the application of the systemic analysis framework to the affairs of particular multinational groups, using the financial performance of marketing distribution companies as a focus. It outlines the competitive market system in which these companies operate and compares how profitability issues have been framed and argued in transfer pricing litigation in Australia. The analysis shows how compartmentalised approaches to these issues can disconnect the factual representations and legal arguments from the real world in which the taxpayer is operating and threaten to undermine the public policy objectives of the transfer pricing rules. By comparison it demonstrates how the use of the systemic analysis framework allows the real transfer pricing issues to be identified and addressed by the courts - and through legislative changes if necessary.

Chapter 11 discusses the vital role the ATO plays in assuring compliance by multinational groups. It posits that the primary strategic purpose of the ATO, as it is with other heads of revenue and taxpayer populations, is to optimise the company tax base (as defined by the company tax provisions) and to make recommendations for improvements.

The Chapter proposes four interconnected sets of strategic questions as a framework for evaluating the ATO's administration of compliance by multinational groups. These questions focus on: the ATO's understanding of its operating environment; an evaluation of how the company tax regime is performing; the strategic focus and operational effectiveness of ATO compliance programs; and matters going to its relationship with the large business sector. The Chapter suggests a strategic framework and an administrative approach to optimise the tax base. It also proposes a more rigorous bottom up methodology for estimating the corporate tax gap.

The Chapter contains an overall evaluation of ATO performance against it statutory mandate and these four sets of strategic questions.

Chapter 12 then draws together the findings and insights that flow from the analyses set out in Chapters 2 to 11. These are grouped in Chapter 12 according to the focus areas selected to test the application of the systemic analysis framework, namely: the positioning of Australia in the global economy; the current performance of the domestic economy; the performance of

Australia's company tax regime; the application of the transfer pricing rules to the facts and circumstances of specific cases; and the role of the ATO in relation to the large business sector.

The Chapter also contains a list of the various parts of the company tax system that are recommended for policy review.

Chapter 2: A systemic approach to tax policy to best position Australia

This Chapter proposes a systemic analysis framework and uses the positioning of Australia within the global competitive market system, the performance of the domestic economy and the operation of Australia's company tax regime as testing grounds. It seeks to demonstrate how policymakers, tax administrators and tax professionals can better understand and manage the complexity of issues that are arising by using the framework to identify and address the underlying structural causes of problems and identifying when and to what extent tax policy settings can make a difference. As a context for this analysis the Chapter presents an overview of how Australia taxes cross-border direct investment and the policy rationale for that approach.

The Chapter describes a set of interconnected diagnostic tools comprising the "Iceberg Model", the mapping of the economic value chains of multinational groups, economic functional analysis and productivity analysis, that allow a more meaningful scrutiny of observable facts, transactions and events, using the analogy of the visible part of the iceberg and what lies beneath. The objective of the framework is to helps stakeholders discern the real problem, whether it is fundamentally a problem that emanates from, or can be addressed in any measurable degree by, the way the company tax provisions are framed and the rate at which company tax is set, or whether some other form of policy response is needed. The suggested approach is designed to also enable the negative spaces to be identified, the missing elements that commercially rational participants and regulators would expect to see or want to create in terms of stocks and flows, competitive advantage and profitability.

While it is inevitable that Australia will need to be responsive to emerging issues on an ongoing basis, the systemic analysis framework is designed to allow Australia to complement this responsiveness with a forward-looking approach that makes public policy more effective and sustainable.

The Chapter explores the structural drivers shaping the current business investment environment in Australia and whether there is evidence of a material positive correlation between business investment and the statutory rate of company tax.

The Chapter uses the competitive market system as a benchmark for examining the breadth, coherence and effectiveness of the existing company tax rules in defining a tax base. This enables an examination of whether the defined tax base is sufficiently aligned with the profit structure and profitability of multinational groups. It examines the impacts of a reduction in the company tax rate at this time in terms of what it might mean for Australia's ability to attract foreign investment and for company tax collections in respect of profits from the existing stock of foreign direct investment.

How Australia taxes cross-border direct investment by multinationals

The following data extracted from Table 2.2 from the Annual Report of the Commissioner of Taxation for the 2015-16 financial year shows the relative importance of company tax as a head of revenue and the trend in company tax collections (net of refunds) since the 2011-12 financial year.

TABLE 1

	2011–12 $m	2012–13 $m	2013–14 $m	2014–15 $m	2015-16 $m
Total individuals	148,373	156,300	163,592	177,860	187,101
Companies	66,608	66,924	67,305	66,946	62,648
Super funds	7,562	7,661	6,101	5,873	6,834
Resources rent taxes	1,463	1,817	1,511	1,870	741
Fringe benefits tax	3,731	3,922	4,077	4,347	4,368
Total income tax	227,737	236,623	242,585	256,896	261,692
Excise	25,545	25,412	26,075	23,663	21,492
Goods and services tax	46,205	48,271	51,366	54,579	57,536
Other indirect taxes	1,143	1,160	1,230	1,312	1,456
Total indirect taxes	72,893	74,843	78,671	79,555	80,485
Superannuation guarantee charge	323	337	395	379	341
Foreign investment application fees	na	na	na	na	78
Total net tax collections	300,953	311,803	321,650	336,830	342,596
Self-managed super fund levy	70	89	137	181	155
Other revenue – unclaimed monies	141	1,190	287	253	604
Total collections	301,164	313,082	322,074	337,264	343,355
HELP/SFSS	1,520	1,625	1,698	1,751	1,907

Source: Annual Report of the Commissioner of Taxation for 2015-16, Volume 1, Table 2.2 at page 39.

Company tax is a tax on adjusted company profits, whether they are distributed to or retained to the benefit of the shareholders. While the accounting profit is a starting point, a series of clawbacks and further allowances are made in the tax reconciliation process to arrive at the taxable income. The statutory rate of company tax is 30%[5]. Tax credits and offsets may reduce the amount payable. Company tax is an important component of Australia's overall tax base net collections for the 2015-16 financial year totalling $62.6 billion.

As presently designed, the broad focus of Australia's company tax regime is to tax Australian resident companies on their worldwide income[6] and to tax the Australian source income (and certain other statutory income) of foreign companies[7], subject to the allowance deductions for losses and outgoings incurred in deriving that income and other specific deductions allowed by the tax law[8]. The effect of these provisions is that worldwide or Australian source company profits (depending on residence) are subject to tax after the allowance of tax expenditures and offsets.

There are two important variations to this broad architecture that are particularly important in the case of inbound and outbound direct foreign investment by multinational groups.

The first relates to foreign resident companies in countries with which Australia has concluded a double tax treaty. Where the investment into Australia does not involve the establishment of a group subsidiary Australia's taxing rights are prefaced on the existence of a sufficient direct economic connection with Australia. This threshold is specified in the Australia's tax treaties for the taxation of business profits as being the existence of a fixed place of business in Australia through which the business of the enterprise is wholly or partly carried on (referred to in the treaties as a "permanent establishment"). If a foreign based multinational carries on business through a permanent establishment in Australia, the profits

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[5] Subsection 23(2) of the *Income Tax Rates Act 1986.*

[6] Subsections 6-5(2) and 6-10(4) of the *Income Tax Assessment Act 1997.*

[7] Subsections 6-5(3) and 6-10(5) of the *Income Tax Assessment Act 1997.*

[8] Sections 8-1 and 8-5 of the *Income Tax Assessment Act 1997.*

of the group attributable to that permanent establishment (PE) – and only those profits – may be taxed in Australia.[9] The provisions of Australia's treaties have effect notwithstanding anything inconsistent in the *Income Tax Assessment Act 1936,* the *Income Tax Assessment Act 1997* or in an Act imposing Australian tax.[10] Accordingly, Australian sourced business profits that are not attributable to a PE, either because there is no PE or the relevant income, profits or gains are not attributable to an existing PE, are not taxable in Australia. However, provisions of the treaties dealing with specific types of income (like those dealing with payments of interest and royalties to entities resident in the treaty partner country) may still have application, allowing Australia to impose withholding tax within the limits contained in the relevant treaty.

The second variation relates to the taxation of foreign source income derived by Australian resident companies. Section 23AH of the *Income Tax Assessment Act 1936* and section 768-5 of the *Income Tax Assessment Act 1997* provide tax exemptions respectively for branch income and non-portfolio dividends[11] derived by Australian resident companies from their offshore PEs and subsidiaries. These exemptions are available regardless of whether tax was paid on the profits in any foreign country. These measures are designed to facilitate the repatriation of profits Australian resident companies derive offshore. Since multinational groups can be expected to structure their offshore direct investment in accordance with these provisions, using wholly owned subsidiaries or branches where full control is desired, the provisions produce the practical effect that the taxation of Australian resident multinational companies is generally confined to their Australian source profits. This is in contrast to the general architecture of Australian tax law which is designed to tax the worldwide income of Australian residents. While returns on offshore portfolio investment remain taxable in Australia, subject to the allowance of a credit for foreign income taxes paid, multinational groups may seek to structure their portfolio investment through their offshore subsidiaries to avoid Australian tax. However, in some situations the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* may preclude this effect.[12]

The broad effect of these two variations, assuming that multinational groups take advantage of the tax structuring options available to them, is that Australian company tax is generally limited to Australian source profits in the case of both foreign based and Australian based multinationals. Part X of the *Income Tax Assessment Act 1936* contains protections against the accumulation of passive income in offshore entities and of tainted sales and services

[9] This effect is achieved by the combined operation of the Permanent Establishment and Business Profits Articles in Australia's tax treaties. See for example Article 5 (Permanent establishment) and Article 7 (Business profits) of the Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, Australian Treaty Series [2003 ATS 22].

[10] Subsection 4(2) of the *International Tax Agreements Act 1953*.

[11] Section 768-15 of the *Income Tax Assessment Act* 1997 stipulates that the minimum participation required for the exemption is 10% which aligns with the generally accepted distinction between portfolio and non-portfolio investment.

[12] Part IVA has regard to the form and the substance of arrangements in the determination of whether a dominant tax avoidance purpose exists (subparagraph 177D(b)(ii)). Compare also *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 414; 96 ATC 5201, a case involving the placement of $40 million surplus cash generated in Australia through a Cook Islands tax haven structure at 4% less than the Australian bank bill rate in order to exploit tax rate differences to obtain a higher after tax return.

income from dealings with associates that give rise to profits in offshore conduit companies, but otherwise allows controlled foreign companies (like their competitors in those markets) to operate subject only to the tax regimes of the host countries.[13]

Prima facie, the architecture of Australia's company tax regime seems to align with competitive neutrality as a design intention on the Australian side for both onshore and offshore active business operations, though consideration needs to be given to the practical operation of those rules (including Australia's imputation and thin capitalisation regimes) and the relative influence of any other (non-tax) factors that may affect competition between Australian based and foreign based multinational groups.

There is a close connection between the taxation of Australian resident companies and the taxation of their shareholders. The taxation of company profits and the flow of those profits to parent companies and ultimate shareholders is an issue for all countries and each country has to address how it will tax resident and non-resident shareholders. It is internationally recognised that the economic double taxation of company profits can inhibit direct investment[14] and tax treaties seek to assist cross-border investment by requiring (on a reciprocal basis) the country deriving the dividends or branch profits to allow a credit for the foreign tax paid, to the extent that the domestic laws of the receiving country allow such credits. In some circumstances these foreign tax credit regimes have been rendered redundant by countries allowing tax exemptions for foreign profits that are repatriated in the form of dividends and for profits derived through foreign branches.

In Australia dividends[15] and revenue profits[16] and capital gains[17] on the sale of shares (subject to any discount that may be available) constitute assessable income, though specific exemptions apply to dividends and branch profits earned from offshore direct investment (discussed above).

In order to prevent economic double taxation of company profits in the domestic context it is a design feature of Australia's company tax regime that the payment of company tax by an Australian resident multinational company creates an imputation (franking) credit, based on the 30% statutory company tax rate, that is available to Australian shareholders to reduce the income tax they would otherwise pay on the dividends they receive[18]. This means that

[13] See for example section 432 (the active income test which specifies that gross tainted income must be less than 5% of gross turnover for a company to pass the active income test), section 446 (passive income) section 447 (tainted sales income) and section 448 (tainted services income). Section 435 provides that the gross tainted turnover comprises passive income and tainted sales and services income.

[14] A holding of 10% or more is generally regarded as direct (or non-portfolio) investment for the purposes of double taxation agreements.

[15] Section 44 of the *Income Tax Assessment Act 1936.*

[16] Profits from the carrying on of a business of trading in shares would constitute ordinary income and be included in assessable income by virtue of section 6-5 of the *Income Tax Assessment Act 1997.*

[17] Part 3-1 of the *Income Tax Assessment Act 1997*.

[18] Part 3-6 of the *Income Tax Assessment Act 1997*. Section 200-5 describes the imputation system in the following terms:

> "The *imputation system partially integrates the income tax liabilities of an Australian corporate tax entity and its members by:
> (a) allowing the entity, when distributing profits to its members, to pass to those members credit for income tax paid by the entity on those profits; and
> (b) allowing the entity's Australian members to claim a tax offset for that credit; and

dividends paid out of fully taxed profits that flow from one Australian company to another Australian company are not subject to further taxation. Generally speaking, Australian individual shareholders whose taxable income does not exceed the tax free threshold of $18,200[19] can obtain a refund of the imputation credit[20]. Imputation credits are generally more beneficial for resident individual taxpayers with taxable incomes less than $37,000, the stage at which the personal tax rate increases from 19% to 32.5%[21]. Tax exempt Australian institutions that directly or indirectly receive franked dividends from Australian resident multinational companies can also obtain a full refund of the imputation credit[22]. Complying superannuation funds can obtain a 30% franking credit offset even though they are generally subject to a 15% statutory rate of tax[23] and may be entitled to a refund[24].

To the extent that non-resident shareholders derive income that consists of the franked part of a dividend paid by Australian resident companies they are not subject to Australian dividend withholding tax[25].

The domestic operation of Australia's imputation system means that changes in the statutory rate of company tax have flow-on effects in increasing or reducing the amount of tax Australian resident shareholders have to pay on their dividend income. For example, where there is a reduction in the statutory rate of company tax the flowthrough in lower imputation credits, without tax relief at the shareholder level, would logically increase the tax burden on some other classes of taxpayer (like individuals and superannuation funds) and reduce imputation refunds for tax exempts. An increase in the statutory rate would have the opposite effects.

In the cross-border context a reduction in the statutory rate of Australian company tax increases the after-tax rate of return to the foreign shareholders and reduces the tax revenue from the existing stock of foreign investment. It would then be a matter for the foreign country as to how it taxes those shareholders, though there is a likelihood that they would pay more tax if they are resident in a country whose shareholder rate of tax exceeded the reduced rate of company tax imposed by Australia. Other factors will also impact the tax position of

(c) allowing the entity's Australian members to claim a refund if they are unable to fully utilise the tax offset in reducing their income tax."

[19] See endnote xiii.

[20] Division 67 of the *Income Tax Assessment Act 1997.*

[21] Schedule 7 of the *Income Tax Rates Act 1986* sets out the following rates for resident taxpayers:

Tax rates for resident taxpayers

Item	**For the part of the ordinary taxable income of the taxpayer that:**	**The rate is:**
1	exceeds the tax‑free threshold but does not exceed $37,000	19%
2	exceeds $37,000 but does not exceed $80,000	32.5%
3	exceeds $80,000 but does not exceed $180,000	37%
4	exceeds $180,000	45%

Section 3 of that Act defines the tax free threshold as $18,200 and section 20 provides that this allowance is pro-rated in cases where the taxpayer is not a resident of Australia for the full income year. Section 34 provides by way of a "temporary budget repair levy" for an additional tax of 2% on the part of the ordinary taxable income that exceeds $180,000.

[22] Section 67-25 of the *Income Tax Assessment Act 1997*.

[23] Section 26 of the *Income Tax Rates Act 1986*.

[24] Section 67-25 of the *Income Tax Assessment Act 1997*.

[25] Paragraph 128B(3)(ga)(i) of the *Income Tax Assessment Act 1936*.

those shareholders, including whether the stock is positioned as a capital growth or dividend stock, the dividend and reinvestment policies of the parent company and any capital management strategies that may be available to the group (for example, share buy-backs). It is only when all these factors are taken into account across the value chain comprising both the parent company, its subsidiaries and its shareholders that it is possible to determine the likely net effects of a reduction in the rate of company tax in Australia on foreign parent companies and their shareholders. However, senior corporate managers of groups with existing operations in Australia that have not optimised their market position may be encouraged by higher after-tax returns to invest more if the business opportunities are there and they are more attractive than other options. It may also encourage new investment at the margin, depending on the full range of factors multinationals have to consider in deciding whether or not to establish themselves in the Australian market (discussed further below).

Tax exemptions and concessions provided in the Australian tax system create the potential for an Australian company's accounting profit to exceed its taxable income, the surplus sometimes referred to as "excess accounting profits". The effect of the exemptions and concessions is that the rate of tax on the accounting profit is below the statutory 30% company tax rate. Tax credits and tax offsets, which reduce the amount of company tax that is payable, also reduce the effective rate of tax on the overall accounting profit below the statutory 30% rate.

The potential impacts of Australia's company tax system on global economic value chains and decisions by foreign based multinationals to invest in Australia are separately discussed below.

Special considerations in relation to dividend and interest withholding taxes

Where foreign based multinationals distributed those excess accounting profits or lower taxed accounting profits to the offshore holding company dividend withholding tax (DWT) of 15% traditionally applied to the extent that the dividends were paid out of profits that were not fully taxed at the 30% rate. In other words, in Australia's case the withholding tax operating as a partial clawback of the tax foregone through the tax expenditures, credits and offsets. A design difficulty with DWT in relation generally to countries involved in global investment is its effect in impeding the flow of profits, resulting in an accumulation of profits in the foreign source country in circumstances where the offshore subsidiary would have otherwise repatriated them because the funds were not needed by that entity for reinvestment. However, despite that impediment, the excess accumulated profits could still be made available in various ways to other parts of the group needing cash. In other words, the DWT regime was largely ineffective as a clawback mechanism, it distorted the flow of profits, and its attempted circumvention led to tax avoidance practices in the country that created the surplus cash and in the borrower country that used the surplus cash. For Australia, as a net importer of capital, the ability to repatriate significant amounts of offshore profits was the most important consideration.

Beginning with the conclusion of a Protocol to the double tax convention between Australia and its major investment partner the United States, Australia responded by adopting a new negotiating position of seeking to remove or significantly reduce DWT on dividend flows in respect of direct foreign investment. Article 6 of the concluded Protocol contains a DWT exemption where the investor country holds 80% or more of the voting power in the relevant US or Australian company and a 5% DWT where 10% or more of the voting power is held.

The Protocol was given the force of law in Australia by the *International Tax Agreements Amendment Act (No 1) 2002*. The Explanatory Memorandum to the Bill (General outline and financial impact section) stated,

> "The Protocol will remove withholding tax on certain dividends, enabling major Australian public companies to bring profits made by their subsidiaries back to Australia without further tax being payable. This measure will provide a benefit to the majority of Australian corporate groups with US operations.
>
> Dividends derived by companies from other direct investment (where the shareholding is 10% or more) will be subject to 5% withholding tax (down from 15%)."

The US Protocol became a turning point for treaties with other major investment partners like the United Kingdom[26].

Some observations can be made regarding the changes to DWT. First, it is important to understand the separate impacts tax measures may have on the flow of profits as well as on the initial location, quantification and primary taxation of those profits. Secondly, there is a greater need to ensure that there is a sound economic justification for any tax expenditures since there is now no partial clawback. Thirdly, the role of tax preferences seems to be unclear and the attitude of policy makers probably ambivalent, since preferences may produce positive impacts in relation to domestic economic activity but also reduce the effective rate of company tax, which carries a revenue cost. While that might be thought to be a lower overall revenue cost than a cut in the statutory rate of company tax, the actual revenue costs of the preferences need to be accurately calibrated and able to be effectively managed. Nevertheless, unless they can be accessed by all market participants they adversely impact on the economic efficiency of resource allocation across the Australian economy and, potentially, on competitive neutrality. They also become a focus for tax planning.

Interest expenses incurred by Australian companies and branches are generally tax deductible (with a tax effect of 30%) but any payments may be subject to withholding tax[27]. To the extent that debt funding has been borrowed from an offshore affiliate, interest withholding tax of 10% is payable when interest payments are actually made[28]. However, section 128F provides for an exemption if debt funding is raised through publicly offered debentures and debt interests, even where the funds are raised by a subsidiary finance company whose only business is raising funds for its parent. In the absence of such an exemption the market would pass on the cost of the withholding tax to the borrower, increasing the cost of capital, something that is not seen as acceptable in public policy terms given Australia's need to access global capital.

A number of Australia's tax treaties, including those with the US and the UK, contain interest withholding tax exemptions where the interest is derived by a financial institution which is

[26] See clauses 2 and 3 of Article 10 of the Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland that entered into force on 17 December 2003.

[27] Subsections 128B(1A), (2), (2A) and (5) of the *Income Tax Assessment Act 1936*.

[28] Subsection 128B(2) requires that interest must be derived by and paid to a non-resident for withholding tax to apply. This requirement is also reflected in Australia's double taxation agreements, usually in paragraphs (1), (2) and (7) of Article 11 (Interest), as is the case in the US and UK agreements.

unrelated to and dealing wholly independently with the payer. The term "financial institution" means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

Accordingly, in so far as independent external wholesale and financial institution financing is concerned, Australia's tax policy settings are designed to have the overall result that the interest expenses are generally tax deductible subject to thin capitalisation limits[29], discussed further below. However, the interest paid by Australian entities on the debt raised through public offers in Australia or overseas, or from overseas financial institutions in certain major financial centres is not subject to interest withholding tax. This ensures that the tax policy settings increase Australia's access to foreign debt capital and reduce, or at least do not increase, the cost of that foreign debt capital for businesses operating in Australia. (See also the later section in this Chapter entitled *Ineffectiveness of compartmentalised approaches to major policy issues*.)

Where an offshore associate provides debt funding that has been sourced from the group's retained earnings, capital raising or the proceeds of sale of foreign assets, the interest on that debt is subject to 10% interest withholding tax, but only when the interest amount is actually paid out of Australia, allowing the withholding tax liability to be indefinitely deferred.

The "Iceberg Model" and criteria for evaluating the Australia's company tax regime

In order to understand how well Australia's company tax system is operating, as to whether it appropriately serves Australia's revenue requirements and broader economic, social and political interests, a systemic approach is needed that has regard to:

- the structural drivers and dynamics impacting on Australia and how well Australia is positioned internationally;
- how the competitive market system actually operates in practice and is impacted by global, country, market and individual firm level factors;
- the global economic value chains of multinational groups, their business structuring and their tax structuring;
- the manner in which profits are recognised and calibrated by multinational groups within the competitive market system;
- the degree to which the operation of Australia's tax rules aligns with the way the competitive market system operates in practice;
- how those rules impact on the economic value chains of multinational groups (see Figure 2 below);
- the soundness of any public policy basis for divergences between tax rules and the competitive market system;
- structural connections between different parts of the tax system relevant to the taxation of multinational groups and whether they form a coherent set of rules for the taxation of company profits; and
- interactions between Australia's tax system and those of other countries, including the tax attributes those systems confer on shareholders and flows.

The overall analytical approach adopted in this paper can be represented as the Iceberg Model shown in Figure 1 below. The idea that there are deeper underlying influences that are

[29] These limits are set out in Division 820 of the *Income Tax Assessment Act 1997*.

responsible for the things we can observe is not new. In Chapters 10 and 11 of his book, The Five Literacies of Global Leadership[30], Dr Richard Hames explores his management theories of Strategic Navigation and Deep Design which can equally be applied in a business context, public policy and administration, and international relations. His chapter on Deep Design includes a version of the iceberg model. The following analysis seeks to adapt the general iceberg model and apply its underlying concepts to the context of Australia's position in the global economy and the performance of Australia's rules for taxing the activities of multinational groups operating in Australia. That adaption also seeks to throw light on any elements that may not be observable in the current system but that Australia would want to include in its definition of success for global positioning and tax policy settings; in other words, what is not there (or is insufficiently present) but would be in Australia's national interest to foster.

The analytical model first requires the definition of the "system in focus". While the tax rules applying to multinational groups are a key part of that "system" there is a need for wide peripheral vision in properly defining the scope of inquiry. For example, the company tax provisions have to operate in a wider socio-economic context that may also be affected by new technologies, environmental factors, political considerations and major ethical debates. Accordingly, the "system in focus" has to be defined broadly enough to consider these potential impacts. For example, e-business has disrupted traditional distribution channels raising new questions about the application of source and residency rules in an environment where the boundaries between traditional forms of trade and investment are becoming blurred. Bitcoin may have disruptive potential for financial markets and regulation. Environmental factors may affect the availability of finance, risk cover and the way insurance risk is priced. Technologies to harness new forms of energy are disrupting established networks and markets and may affect the availability of capital. Government regulation of mineral and gas exploration and land releases, government approaches to infrastructure development (including transport, energy, space research, technologies and regional development) present further examples of potential drivers or limitations that can affect investment, productivity, profitability and thus the performance of the company tax system. Industry, education, training and employment policies will affect the extent of the demand on the tax system for the funding of a social safety net. The allocation of powers between the Commonwealth and the States may in some cases be a political driver of outcomes affecting industry, overall economic performance and the revenue needed at the Commonwealth level. Housing, construction, water resource management and energy markets are current examples. In terms of the global allocation of capital, sovereign and country risks may present other issues affecting a country's ability to attract investment (though the evidence below does not suggest that this is currently a problem for Australia).

There may also be emergent issues in the global political context, like free trade and protectionism and the consideration of whether different forms of capital taxation might better protect the interests of individual countries. The consideration of cashflow taxes, the balance between personal, capital and consumption taxes and the increasing resort to tax competition are examples. These issues need to be taken into account in any systemic analysis of the efficiency, effectiveness and sustainability of Australia's company tax regime.

All of these issues are part of the tapestry that Australia and multinational businesses have to consider in order to best position themselves. They must therefore form part of the context

[30] Jossey-Bass, 2007, ISBN 978-0-470-31912-3 (HB).

for evaluating Australia's company tax regime. The correct framing of that context carries with it the imperative to adopt an analytical approach that connects firm level, national and global factors and impacts.

Within the "system in focus" there are patterns of activity (or non-activity) that can inform the systemic analysis. Those patterns can occur at a global level, economy-wide level or at the microeconomic level. So, for present purposes, this includes markets, the economic value chains of multinational groups and the business operations of the companies or branches in Australia, and their dealings with other parts of the multinational group. It is the drivers and economic and financial implications of those patterns and trends that are important. This is because, in the cross-border context, company tax is primarily based on an arm's length measure of profits derived from the dealings of independent parties in the competitive market system, subject to tax reconciliation adjustments, tax credits and offsets[31]. Market surveys of the structuring and implementation of commercial and financial relations between independent parties dealing wholly independently with each other can inform the analysis as to whether there is anything contrived or artificial in the commercial or financial relations between related parties, whether independent parties would have entered such relations, or whether there is anything missing that independent parties behaving in a commercially rational manner would have insisted on including. (These elements are now captured in the transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997*.)

The Iceberg Model recognises the importance of human behavioural elements in trying to understand the current performance of the company tax system and in developing the necessary agility and responsiveness to address issues that might affect ongoing viability. For example, world views about the nation state, its sovereignty and its relationship with its citizens, individual rights, the role of government, the role of markets, shareholder interests, the accountability of corporate directors and managers for profit performance, the roles of capital and labour, the payment of taxes, competition, the rule of law, the interpretation and application of legislation, all potentially drive attitudes to the tax system, tax policy settings, participation in consultative processes and the nature of the relationships between government, industry and tax administrations. Any change to the company tax regime has the potential to prompt a behavioural response; whether in terms of avoiding a change that will increase the amount of company tax payable, exploiting a loophole or, hopefully, pursuing the course of conduct that the tax policy settings are aiming to encourage, whether that be tax compliance or some broader social or economic objective. So, the analysis of tax drivers has a very important behavioural component.

In so far as the tax law itself is concerned, the systemic approach requires the creation of a narrative about the purpose of the relevant provisions and a conceptualisation of what tax behaviours and metrics would be observed if the tax policy was being effectively implemented. This needs to be reflected in the language used in the statute since the judicial role of applying the law is constrained by the extent to which the legislation contains a clear articulation of its purpose and comprises a coherent framework, and is assisted by arguments that are properly framed within the parameters of the legislation. For public policy objectives

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[31] For example, section 129 of the *Income Tax Assessment Act 1936* provides that the taxable income of the owner or charterer of a ship whose principal place of business is outside of Australia is 5% of the amount paid to that person in respect of the carriage of passengers, livestock, mails or goods shipped in Australia. Section 143 of that Act provides that the taxable income of a non-resident insurer is calculated as 10% of the premiums unless the insurer satisfies the Commissioner of Taxation that its actual profit or loss in respect of those premiums was a lesser amount.

to be achieved the impacts of tax laws have to be measurable against benchmark metrics, or "goalposts", formulated by reference to what one would be seeing in practical real-world terms if the relevant tax policy were successfully implemented. For example, the set of interdependent metrics might include:

- trends in direct investment flows;
- trends in company tax collections relative to GDP;
- a basket of effective tax rate measures, comparing tax paid to income, assets, expenditure and accounting profits;
- the trend in the debt to equity ratio for the Australian operations and comparisons with the trend in the entity's Australian asset values and with the multinational's worldwide gearing ratio;
- trend in interest expense claims relative to earnings before interest and tax (EBIT) and comparisons of the subsidiary's and the group's weighted average cost of debt (WACD);
- Berry ratio analysis[32];
- adjusted Berry ratio analysis for capital intensive industries[33];
- the relative tax performance in Australia of Australian based and foreign based publicly listed multinationals;
- profitability analysis of Australian operations relative to overall group performance and the foreign owned subsidiary's "economic footprint" in Australia;
- the incidence of tax haven and concessional regime structures;
- trends in the reported values of related party dealings in respect of items of income and expense relative to reported accounting profits; and
- an evaluation of the reported profits and rates of return in Australia compared to the profits and rates of return achieved by the multinational group as a whole.

For example, if the thin capitalisation safe harbours were aligned with the worldwide gearing of the multinational group, interest expense claims as a proportion of EBIT should reduce for entities previously using concessional safe harbours, due allowance being made for market movements in relevant interest rates and economic conditions. Moreover, there should be a better risk weighted correlation between the gearing of the Australian subsidiary and the capital structure the multinational group as a whole has adopted to optimise its access to capital at the best price. Rates of interest paid on the Australian side would be close to those paid by the group as a whole. Where interest expense claims do not reduce, the subsidiary's asset values could be analysed to ensure they have not been inflated relative to the asset values used for the process of consolidating the group's financial statements. The group's WACD and borrowing costs for contemporaneous external funding may also provide insights as to the reasonableness of any margin charged on intra-group loans.

[32] The Berry Ratio examines the relationship between the gross profit margin and the operating expenses of an entity.

[33] The purpose of constructing an adjusted Berry Ratio would be to develop a proxy for the annualised investment made by an entity, taking account of the depreciation of fixed assets and inventories. The annualised investment provides a benchmark for evaluating the reported rate of return by reference to appropriate market rates of return to assess whether it is commercially realistic and the extent to which it may fall short.

The analysis of Australian accounting profits relative to the risk-free rate of return in the Australian economy, patterns of losses and profitability relative to competitors may also provide useful insights. A number of these are discussed in more detail below.

If the articulation of the policy in the enacting legislation does not lend itself to the specification of appropriate metrics to examine cause and effect, then there is no way of knowing whether the purposes behind particular tax policy settings have been achieved – or at what revenue cost. In other words, their costs and benefits have to be measureable. Given their relative significance, specific measures should be developed for Australia's thin capitalisation, capital allowances, tax consolidation and transfer pricing regimes.

FIGURE 1

The "Iceberg Model" – Levels of analysis, thinking, conversation and intervention

In the competitive market system all levels are connected and research and feedback loops are needed to make meaning of what is occurring and identify opportunities for leverage and reform so the system can appropriately co-evolve.

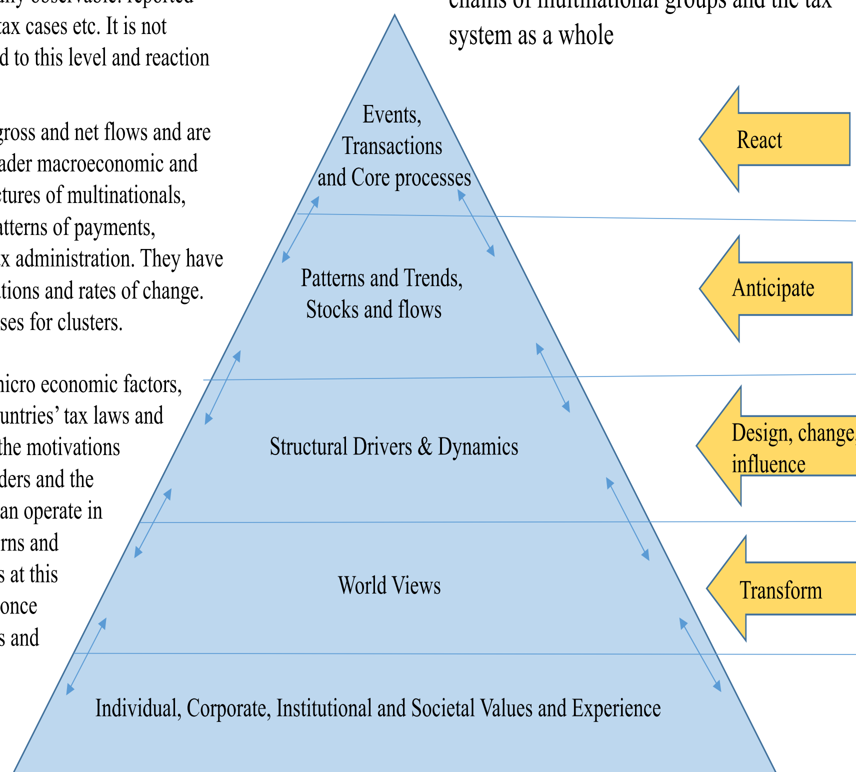
The "system in focus" is the operation and impacts of company tax within the context of the competitive market system, global value chains of multinational groups and the tax system as a whole

The tip of the "iceberg" is confined to things that are readily observable: reported profits, cost of capital, amounts of tax paid, decisions in tax cases etc. It is not possible to make systemic meaning if thinking is confined to this level and reaction is the only available behavioural response.

The relevant patterns and trends, stocks and flows cover gross and net flows and are occurring within the system in focus, including in the broader macroeconomic and market context, the economic value chains and legal structures of multinationals, their global and Australian financial statements and the patterns of payments, effective tax rates and technical issues identified by the tax administration. They have to be formulated and analysed for distributions, concentrations and rates of change. This allows stakeholders to anticipate and develop processes for clusters.

The structural drivers and dynamics include macro and micro economic factors, firm level imperatives, the structure and interaction of countries' tax laws and the tax attributes they confer on shareholders and flows, the motivations and risk appetite of multinational managers and shareholders and the quality of the tax administration. Drivers and dynamics can operate in different directions producing net outcomes and the patterns and trends, stocks and flows observed within the system. It is at this level that reform and tax system improvement can occur once the relative strength and relationships between the drivers and dynamics are understood and able to be managed.

Where differing world views are able to be accommodated, or compromises achieved, major structural reform can occur and transform the system.



The "Iceberg Model" can be applied at different levels of the competitive market system, provided connections are made to the other levels. For example, the trends in the aggregated transactional data set out in Table 1 above, formatted as a comprehensive list of heads of revenue across a series of financial years, provides a number of insights about Australia's tax base[34].

[34] A longer series would provide even more insights.

Using the data in Table 1, the following table gives a broad indication of the relative significance of taxes on capital, labour and domestic consumption in the overall mix of Australian tax revenue.

TABLE 2

Financial year % of total net tax collections	2011-12	2012-13	2013-14	2014-15	2015-16
Company tax	22.13	21.46	20.92	19.88	18.29
Total individuals	49.30	50.13	50.86	52.80	54.61
Goods and Services Tax	15.35	15.48	15.97	16.20	16.79

Source: Annual Report of the Commissioner of Taxation for 2015-16, Table 2.2.

The data in Table 1 also allows the rates of change in taxes by head of revenue to be ascertained.

TABLE 3

Financial year	2012-13	2013-14	2014-15	2015-16
Change in net company tax collections	+0.5%	+0.6%	-0.6%	-6.4%
Change in net individuals tax collections	+5.3%	+4.7%	+8.8%	+5.2%
Change in net goods and services tax collections	+4.6%	+6.4%	+6.2%	+5.3%

Source: Annual Report of the Commissioner of Taxation for 2015-16, Table 2.2.

The following observations can be made in relation to the trends in net collections. Having risen from $66.6 billion in 2011-12 to a peak of $67.3 billion in 2013-14 net company tax collections have been declining, reaching $62.6 billion in 2015-16, $4 billion less than at the start of the period.

Individual tax has risen from $148.4 billion in 2011-12, at an increasing rate over the latter part of the period, to reach $187.1 billion in 2015-16, $38.7 billion more than at the start of the period.

Goods and Services Tax collections have increased from $46.2 billion in 2011-12, at a slightly slowing rate of change over the last three years, to $57.5 billion in 2015-16.

The trends in individuals and GST tax collections suggest possible increases in the use of labour and in domestic consumption, subject to any movement in factors like prices, in hourly wage rates, tax deductions against salary income and bracket creep. The cash economy is also an issue. However, the trend in company tax suggests a possible decrease in company profitability, an increase in the use of tax concessions and offsets, or an increase in tax avoidance. To some extent each of these may be in play. An examination of the structural drivers and dynamics affecting employment, consumption, business conditions and tax expenditures over the relevant years (allowing for any time lag between the year of income for companies and the company tax collections) will help clarify these issues and potentially identify any anomalies. Patterns and trends evident in the national accounts statistics can also assist this process, subject to any data integrity issues that might arise from the sources of the data and the purposes for which it was created (see below). For example,

opportunities for profit shifting and other forms of tax avoidance might require greater care in examining any correlations between corporate profits, gross operating surplus (GOS) and GDP - and between company tax and other heads of revenue.

The primary focus of the deeper analysis is to determine the relative extent to which the collections trends for each of these head of revenue is being driven by global, domestic or firm level economic factors, tax policy settings (including tax expenditures, the coherence of the company tax code and any legal loopholes) and tax avoidance.

In the case of company tax, the establishment of sufficiently reliable objective measures of economic profitability and of the responsiveness of economic activity and tax avoidance to tax policy settings to assist this process are explored below. Once a reasonably clear impression of the scale of these different types of impact can be ascertained, it becomes easier to make judgments about the appropriateness and effectiveness of tax policy settings, whether tax base protection measures are needed, the adequacy and capability levels of administrative resources to support compliance with tax laws and the effectiveness of compliance strategies.

Tax policy settings can improve or adversely affect Australia's international position and can distort Australia's financial standing and competition between Australian based and foreign based multinational groups. Accordingly, they operate to best effect when they are designed in a way that reflects and co-evolves with the competitive market system, where decisions are made on the basis of commercially rational judgments about the underlying economics in order to optimise pre-tax profits.

Were this to be the case, and absent any major factors affecting global markets, one would expect to see:

- macro trends reflecting Australia being in a strong competitive position in relation to trade and investment (which the data below suggests); and
- correlations at the firm level between economic productivity, economic profitability, taxable income and payments of company tax on the Australian side of the business, subject to the impacts of tax expenditures and tax avoidance (aspects still to be tested).

Realistically, though, it would be expected that multinationals will also seek to optimise after-tax profits, so the expected correlations between economic productivity, economic profitability, taxable income and company tax payments will be impacted by tax expenditures, tax offsets and tax avoidance. This is discussed in more detail below.

The dynamic nature of systemic analysis and the tax significance of intra-group dealings

The systemic analytical process is necessarily a dynamic one that has regard to changes in the structural drivers and dynamics and the flexibility multinational groups have to structure (and restructure) their internal group asset holdings, related party dealings, funding and cashflows. This flexibility may produce financial impacts that obscure or disguise the real economic contribution made by individual subsidiaries or branches (either overstating or understating the contribution).

The economic forces that drive revenue efficiency, cost efficiency and profitability in dealings between independent entities within the competitive market system can break down in the highly vertically integrated structures and processes adopted within multinational groups. Multinational groups do not have to ensure that subsidiaries are established and

operate as separate profit centres and that arm's length margins are allocated to each stage of their economic value chain. What matters to the multinational is that profits are maximised by the group as a whole. The parent company can control the profit levels of its Australian subsidiaries; a business model that can have seriously negative impacts on competition between participants in Australia's domestic markets and on Australia's ability to ensure it gets its fair share of revenue on the profits generated through the operations in Australia.

Since dealings between members of a corporate group wash out on the consolidation of the group's financial statements, but may be recognised in the country in which a subsidiary or branch is operating, internal group structures and related party dealings create the potential to increase the group's cashflows by reducing taxes through various cross-border strategies including profit shifting, earnings stripping or value stripping, or through inappropriately accessing tax expenditures. These risks may be lessened where the subsidiaries or branches are established and run as independent economic profit centres, though multinational groups have strong incentives - including their need for globally coordinated business, group financing and taxation strategies - to run their operations on a globally integrated basis. So, a further question arises as to whether Australia's tax laws, and the administration of them, operate in a way that produces a reflex of assets, cashflows, profits, gains, losses, income and expenditure flows of the companies and branches of multinational groups operating in Australia that is commensurate with the economic realities on the Australian side.

Understanding the economic value chains of multinational groups and how tax impacts

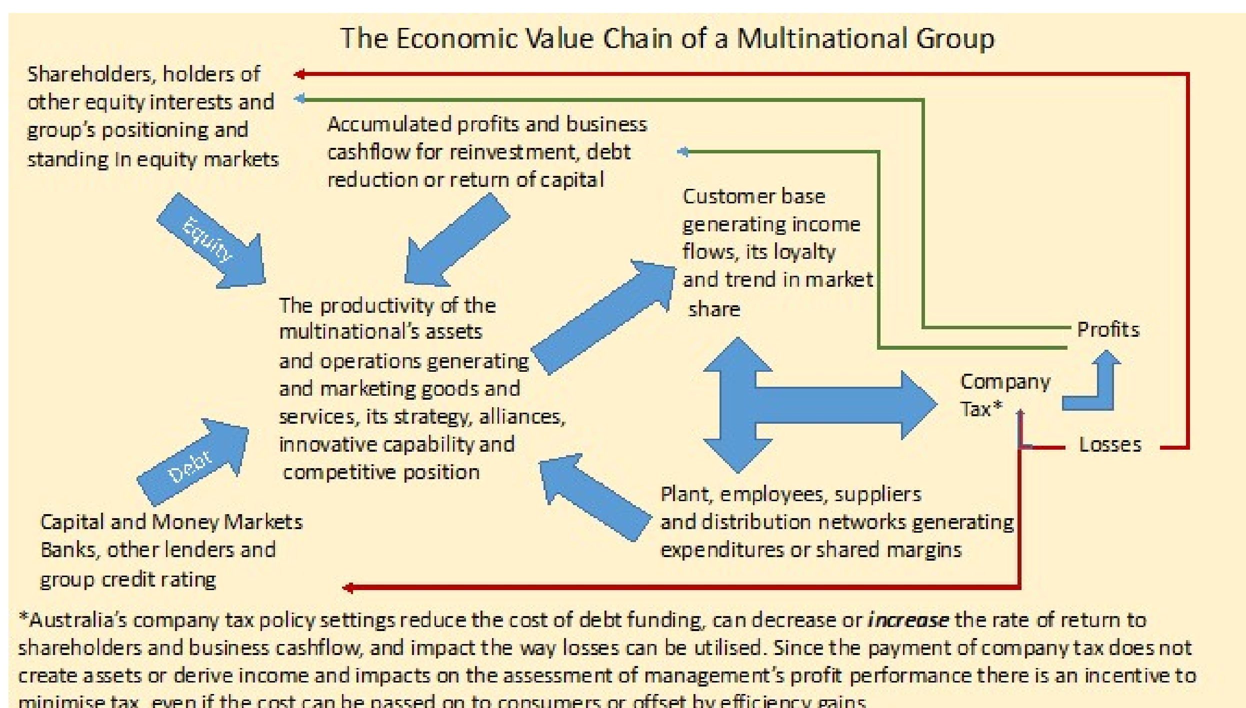
A systemic approach to tax policy settings requires a conceptualisation of the economic value chain of a multinational group in a way that includes the owners of the equity capital and the various providers of debt capital, the internally generated and externally supplied stocks and flows of goods and services comprising the business operations, the customer bases generating the revenue flows and the competitive forces at play[35]. This is represented in the Figure 2.

While one option may be to reflect a value chain solely in a linear quantitative flow of inputs and outputs, this will mask important qualitative factors at the firm level that allow it to successfully respond to the competitive dynamics that businesses have to face and the choices they have to make between reinvestment and providing returns to shareholders. These qualitative factors are core capabilities that allow the firm to evolve and adapt to the changes that have been occurring in the markets in which they operate. The market evolution from transactions to relationships with a customer base makes market research, market position, marketing and distribution channels and customer loyalty strategic issues for the business. Part of this is the consistent production of high quality reliable products and services which the manufacturer is prepared to support. Another part is the development of a market strategy, placement, collaboration, alliances, easy access to products and services, loyalty programs, reputation and differentiation that signal to the market why they should prefer one multinational's business, products and services over its competitors', not just on a "one off" basis but as a longer term strategic partnership, or at least repeat business, brand loyalty. The

[35] In his book "Competitive Advantage, Creating and Sustaining Superior Performance" (1985, The Free Press, republished in 1998 with a new introduction), Professor Michael E. Porter of the Harvard Business School sets out a framework for analysing competitive forces and thinking strategically about the activities involved. Some of those elements are reflected in discussions and in the global value chain diagram.

ongoing viability of such businesses is underpinned by an ability to innovate; both in terms of making existing products and services better and also understanding the opportunities to create new products and services that are likely to be supported by end users.

FIGURE 2

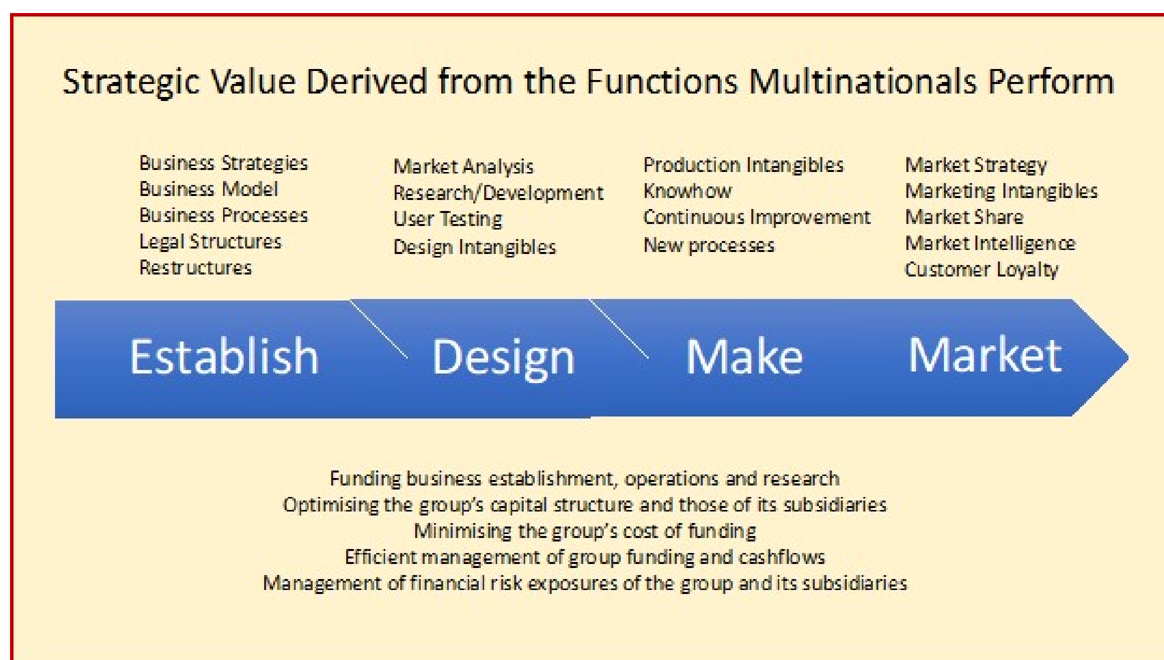


A multinational group can also derive significant strategic advantage from the ongoing reflection on what it learns from the performance of its core functions. Each of these functions can inform the multinational about how its business is going, what is happening in its business environment and the risks and opportunities that are presenting, and how its relationships with its stakeholder and customers are going.

Figure 3 shows the strategic capabilities and advantages a multinational group, or any institution, can derive from using the strategic framework advocated in this paper to reflect on what difference it is making in its markets and within its business. The experience gained from performing the core business functions provides insights that allow the multinational group to maximise the economic value from what it does and to successfully co-evolve in the competitive market system in which it has to operate. All of these functions are underpinned by financial management, of which global tax management is a key element.

The competitive advantage multinationals seek can only be derived from a deep understanding of the context in which they have to operate, including the various economic contexts, markets, financial systems, legal systems and tax regimes in which they conduct operations as a group and as subsidiary members of that group. Accordingly, the multinational group becomes acutely aware of similarities and differences in those elements and, since it can control each part of its global value chain, it can develop its structures and processes to take best advantage for the group as a whole in a way that entities that are specialised in a particular phase of global production or that are confined to one particular geographic location cannot. This can be better understood by considering the following examples.

FIGURE 3



In some industries the high capital intensity of the producer and the customer may drive strategic partnerships between the different firms or between a firm and particular markets. For example, an iron ore producer and a steel manufacturer each have capital intensive operations that, while they are conducted by independent parties, are interdependent. The iron ore production levels are impacted by the demand (and hence the price) for steel. In broad terms the ore producer needs to achieve prices that cover its costs and allow an acceptable margin for the risk that it is taking. These circumstances necessitate long term strategic alliances between the iron ore producers and the steel mills. The competitive dynamics between the ore suppliers within the sector will also play a role, which are more likely to be driven by longer term aims of increasing market share than short term changes in prices. Nevertheless, the independence between the participants creates an economic tension that drives each stage of the global value chain to protect and enhance its separate economic interests in its dealings with suppliers and customers.

It is the breakdown of these economic tensions in highly integrated global structures and processes adopted by multinational groups that creates the risk of profit shifting and the need for Australia's tax rules to be able to address both the structural and transactional aspects that can be used to shift taxable profits out of Australia. For example, a multinational group does not need to pay its Australian marketing distribution subsidiary what an independent party would require in order to play that role. On a commercially rational analysis the independent party needs a certain rate of return to adequately compensate it for its functions, the assets it uses and the risks it assumes. A highly vertically integrated group does not need to pay its subsidiary that level of return, or any level of return. Accordingly, a foreign based multinational group is in a position to change the competitive dynamics in its favour and at the same time augment its profits by reducing its Australian tax.

Major financial services companies will need to have good relations with and a high level of acceptance in global financial markets in order to grow and refinance at a competitive cost of funds. Internally they will be focussed on their margin between their cost of borrowings and

the interest rates they can obtain through the use of borrowed funds in their business. Fees for services are also important, both for investment banking and retail banking. Return on equity is particularly important since the group's equity is covering the financial risks the financial services company is assuming. Its efficiency in its lending practices and loan management is also important, reflected in its percentage of bad and doubtful debts. Significant market share, geographical and product diversity, adequate capitalisation and low-cost business models are generally seen as reducing the overall risk of a financial services group. However, its global spread, centralised control and ability to financially engineer transactional outcomes gives such a multinational group significant flexibility in orchestrating where its profits will be located and how much global taxation it will pay, subject of course to the efficacy of Australia's transfer pricing legislation and tax administration.

In other sectors the critical links between innovation, production and marketing/distribution have shaped markets and enterprises. The cashflow generated through timely distribution and marketing can be the difference between success and failure as is seen in the contest between VHS and Beta. Some companies excel in research and innovation but are not as adept at getting their products to market. This can affect their cashflow and financial profile relative to their peers. Successful enterprises have both capabilities or use strategic partnerships and acquisitions to achieve them. There are examples in the global pharmaceutical industry and the emergence of strategic partnerships between research institutions and commercial enterprises is another. The more intangible intensive these businesses become the overall group control provides more scope to manipulate the location of intangibles and the charging for their use, should a multinational group be so minded, in order to reduce global taxes.

Complementary to the business model and market strategy is the management and staff capability to drive and sustain the productivity of the firm's assets and operations, both its revenue efficiency and its cost efficiency. All financial ratios can be seen as directly or indirectly related to these two coefficients, to the relationship between them, and the management of capital and liquidity to support them. They are the quantitative measures that determine whether a firm is a market leader, a follower or vulnerable. However, they depend on key relationships between management and staff, the firm and its suppliers, the firm and its distributors and its customers. Over the middle to longer term they also depend on the firm's ability to innovate, to create new and better product and services, to enter new markets, to understand and respond to customer demand, but to also anticipate and shape that demand when opportunities arise.

Critical to a firm's productivity (and hence its competitive position) is its ability to raise debt and equity capital at the lowest cost and use it efficiently. It needs the core capabilities to generate good financial outcomes and a strong financial profile that give it competitive advantages. It has to have the acumen to decide when to invest (and divest), how to best fund that investment at the lowest cost, realise when it has funds surplus to its current and strategic needs, and determine the best ways to use any surplus funds to provide returns to shareholders.

This drive for revenue efficiency and cost efficiency is in turn a driver of globalisation because the possibility of new markets provides an option to increase the revenue efficiency of existing product lines and the opportunity to access lower cost production centres, while also generating other economies of scale. We now see economic value chains spread across

several countries, not only in terms of their production and customer bases but also in terms of their sources of debt and equity capital.

It is important to understand how tax policy settings affect the (global) economic value chains of multinational companies operating in Australia, or that may be considering investing in Australia. They can affect the cost of raising capital, depending on how debt and equity are defined for tax purposes, the extent to which tax deductions are allowed for interest expense, the manner in which profits are calculated for tax purposes and the way in which returns to shareholders and debt providers are taxed. Company tax settings can decrease or increase the rate of return to shareholders. For example, tax concessions and offsets will reduce the amount of accounting profit that is subject to taxation or the rate of taxation and thereby increase the returns to shareholders. However, where company tax is actually borne by customers or is offset by improved business efficiencies it does not affect returns to shareholders, unless the tax is avoided by the company, in which case the group gets a windfall.

Other Chapters of this paper discuss in more detail how Australia's company tax regime may impact on the economic value chains of multinational companies. The earlier part of this Chapter contains an overview of how Australia taxes direct foreign investment. The latter part explores the relationship between the statutory rate of company tax and the trend in direct foreign investment. Chapter 4 discusses how Australia's company tax settings would be taken into account when deciding whether to invest in Australia. Chapter 5 discusses the importance of a multinational group's weighted average cost of capital (WACC) and the need to minimise it. The weighted average cost of equity and debt take account of taxes payable and tax deductions and concessions. The ways in which tax settings affect the funding of Australian subsidiaries of multinational groups and Australian based multinationals are discussed in Chapter 6.

Distinguishing tax drivers from social, economic, technological and environmental drivers

The economic value chain of multinational enterprises can be impacted by a range of social, economic, political, technological and environmental drivers and dynamics in addition to any impacts that Australia's tax rules may have. Country risk can impede investment. Global and local economic factors affect productivity and profitability, and hence the climate for investment. It is therefore relevant to consider, in an economic sense, what impacts Australia's company tax regime, as distinct from those other potential drivers and dynamics, has on the returns to owners of capital, their ability to attract and marshal capital, the productivity and profitability of business operations, the customer base and the competitive dynamics.

The critical relationship between multinational groups and their shareholders

It would also be relevant to consider the relationship between the taxation of companies and their shareholders, as well as the more general question of the incidence of company tax on capital, labour and consumers so the total incidence and all the impacts of taxation on economic profits across the various stages of a global value chain can be understood. As a corollary, it is also relevant to consider the impacts in terms of economic stocks and flows or windfall gains across the various parts of the economic value chain caused by tax expenditures and the minimisation or non-payment of company tax - whether through weaknesses in the tax code, tax avoidance arrangements or the availability or unintended

exploitation of tax concessions and offsets. The impact of the tax attributes of shareholders on the group's attitude to tax compliance is discussed in Chapter 3.

Dysfunctional effects of non-alignment of tax policy and the competitive market system

To the extent that the alignment between company tax rules and the competitive market system is not a reference point in the design and evaluation processes there are several potentially undesirable impacts:

(i) the taxation rules potentially overreach and interfere with the proper functioning of markets in relation to Australia's ability to increase its stock of capital for economic growth, its ability to refinance on an ongoing basis and are likely to undermine economic efficiency;

(ii) by under-reaching, whether by not accurately reflecting the full extent of the economic profits or not anticipating behavioural responses by taxpayers and advisers, the taxation rules create arbitrage opportunities in relation to the management of taxation costs - which the market will take advantage of over time through tax planning - or which will create tax base erosion;

(iii) to the extent that the tax policy settings contain an element of concessionality thought necessary to promote Australia's attractiveness as a destination for investment, or to achieve wider social or economic objectives, the revenue costs relative to the social and economic benefits of such concessions will be difficult to reliably measure and they may cause distortions in competition and investment patterns across different sectors of the Australian economy; and

(iv) the non-aligned taxation rules will lack coherence and create additional compliance costs and tax base risk. The problems include the possibility of unwarranted concessions, loopholes, tax driven structures and costs associated with the compilation and reporting of adjusted data sets relative to the information contained in the natural recordkeeping systems required by firms to optimise their economic and financial outcomes.

The interplay of tax policy settings and competitive forces

The economic value chain of a multinational group is impacted by competitive forces. However, as explained in Chapter 2, there is a difference in that there is no market discipline requiring a multinational to allocate commercial margins to each stage of the value chain, as would be the case if independent parties were providing those services. Company tax policy settings affect the cost of debt and equity capital (the weighted average cost of capital or WACC), a critical element in shareholder value and competitive advantage and disadvantage (discussed further in Chapter 5). It seems self-evident that a multinational that is paying no or less tax is in a position to secure a competitive advantage over rivals that are paying more tax, even where in economic productivity terms its competitors are more efficient because the tax savings can operate as a business subsidy to be used as the group sees fit. Accordingly, another important question in the global context is whether Australia's framework for the taxation of company profits is competitively neutral between Australian based and foreign based multinational enterprises in relation to their Australian structures, operations and cost of capital.

Ineffectiveness of compartmentalised approaches to major policy issues

The need for a systemic approach becomes evident from observing the anomalies presenting in the broader economic context, including in relation to financial markets and the effectiveness of monetary[36] and fiscal policy[37], that cannot be explained by traditional compartmentalised thinking and approaches. One has to consider the drivers of corporate behaviour and of the external factors that impact on multinationals but which they cannot control. That environment is complex, dynamic and is continually being shaped and reshaped by both international and domestic factors. Identifying the structural drivers and dynamics in that environment, their effects on Australia, and how to strategically intervene at the key leverage points to best position Australia, necessarily involves a multidisciplinary approach.

An example might help explain the need for a systemic approach. Given the lack of depth in its domestic financial markets Australia has always needed access to foreign debt capital to fund investment, to support domestic borrowing and for refinancing. The deregulation of the financial system in December 1983 enhanced global financing. Australia already had in place an interest withholding tax exemption in section 128F of the *Income Tax Assessment Act 1936* to facilitate the raising of wholesale finance through the issue of widely distributed debt instruments in deep capital markets like Europe and the United States. This was a very attractive and tax effective framework that enabled Australian businesses to raise debt funding at the best available interest rates, though foreign exchange risk would have to be managed.

On 1 July 1986 in Press Release No 65 the then Treasurer, Mr Keating, announced that as a Budget repair measure the interest withholding tax exemption was being repealed with effect from 2 July 1986[38]. Without warning, the established processes in the offshore wholesale debt markets for Australian loans were disrupted. Lenders were faced with a tax liability that would reduce their return by 10% unless the tax was contractually passed on to the borrowers in Australia. It also had the potential to cause losses in transactions where traders of debt securities such as government bonds where the margin on the transaction was less than the 10% withholding tax that now became payable on the interest paid on the debt securities held by non-residents. According to one press report this in turn had the effect that government

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[36] In a speech to the Anika Foundation in Sydney on 10 August 2016 the then Governor of the Reserve Bank of Australia, Glen Stevens, said,
"On the demand side, it seems more difficult to generate growth in spending in an economy where households are already carrying significant debt. The real cash rate has been about 140 basis points lower, on average, than in the preceding decade.[8] So on that metric monetary policy has been easier…..we are living in a world in which the ability of monetary policy alone to boost growth sustainably is very likely to be a good deal more limited than we might wish. I think most people can sense this."

[37] In the same speech referenced in footnote 41 then RBA Governor Glen Stevens, said,
"It's surely no coincidence that the path back to budget balance is turning out to be a very long one. At present, very low nominal GDP growth looms large in subduing revenue growth, because of the terms of trade decline. But when the terms of trade stabilise, weaker potential real growth per head of population will still be a problem. Many difficult choices will need to be made along the path of budgetary adjustment. At present, general public debate starts with commitment to the need for reform and for putting public finances on a sustainable medium-term track."

[38] This press release was referred to in paragraph 9 of IT 2332, which was apparently issued by the Australian Taxation Office July 1986; Notice of Archival dated 9 December 1993.

bonds were "sold heavily" once the markets understood the impact of the tax policy announcement[39] and affected the demand for Australian government bonds. The likelihood that the tax cost would be passed on to the borrower had the financial effect of grossing up the interest rates on debt securities, reflecting the established practice in cases where Australian businesses borrowed from offshore banks rather than through widely distributed debt securities. The foreign tax credits that may be available to foreign portfolio investors in debt securities involved additional paperwork and were only of benefit to lenders who were subject to tax on the interest income derived from Australia.

Some participants in the offshore markets were not prepared to deal with countries that imposed interest withholding tax and Australia found it difficult to make debt issues in several important markets. This reduced the available sources of funding for Australian businesses, the restriction on supply creating upward pressure on borrowing costs. The Australian dollar depreciated by 15.4% from US 67.75 cents at the opening of markets on 1 July 1986 to US 57.3 cents at noon on 28 July 1986 before rebounding to US 61.5 cents at the close after the government announced at 3pm its decision to reverse the proposed repeal of section 128F[40]. While this exchange rate depreciation might initially have been seen as enhancing Australia's global trade and investment competitiveness, it increased the costs of imports and significantly impeded the borrowing capacity of Australian businesses and their ability to service their existing borrowings, thereby producing harmful impacts on investment. The other impact was the generation of further upward pressure on interest rates across the whole of the Australian economy, and the likely passing on of not only the withholding tax costs but the associated overheads. A press report of 29 July 1986 stated the decision to repeal the interest withholding tax exemption "was badly received by the markets and sparked the recent run on the Australian dollar"[41]. The report went on to say that government sources admitted that "the removal of the exemption for Australian securities on public issue overseas, such as Euronotes, was a blunder". It further stated that after a series of meetings between government officials and finance industry representatives over the month, the government conceded the move to repeal the exemption would seriously damage investment.

What this experience highlights is the need to ensure that the frame of reference adopted in policy formulation is broad enough to allow a proper consideration of how a tax policy might impact on the key aspects of the competitive market system, the economic value chains of Australian businesses and Australia's position in the world. Revenue raising cannot be looked at in isolation. The episode also highlights the need to consider the characteristics of the different financial markets, the market participants and what drives their behaviour. The experience underlines a fundamental difference between direct and portfolio investors and how the latter are extremely sensitive and immediately responsive to adverse tax policy changes.

[39] Sydney Morning Herald, Wednesday 2 July 1986, page 22.
[40] Sydney Morning Herald, Wednesday 2 July 1986, page 22 and Tuesday 29 July 1986, page 1. In an address to the Crawford School of Public Policy on 16 September 2014 entitled Public Policy Resilience and the Reform Narrative, Ken Henry a former Secretary of the Australian Treasury noted that the exchange rate depreciated 12% during July 1986 but the tax policy impacts were not a focus of his presentation.
[41] Sydney Morning Herald, 29 July 1986 edition, page 1.

The episode also demonstrates the information vacuums that can arise when complex financial market issues are being considered and the need for effective consultation to ensure that the structural drivers of market behaviour and their likely impacts are understood.

While the impacts of the policy announcement were immediate, the saving grace in the case study was that the policy was able to be reversed within a month of its announcement because the impacts were immediately apparent. Where policy changes confer unwarranted benefits on a taxpayer demographic those impacts may not become overt for a considerable time and their removal may face significant political pressure.

The frame of reference and methodology for effective tax policy settings

A systemic approach to tax policy settings takes account of:

- Australia's overall position as a relatively small, open and financially deregulated economy (see Table 5 below)[42];
- the ability of the Australian economy and individual firms operating within it to generate or otherwise obtain the capital needed for economic development and refinancing;
- possible domestic and foreign sources of capital;
- the responsiveness of global capital markets and major Australian investors to Australia as a location for debt and equity investment;
- factors affecting the cost at which funds are available to Australian businesses; and
- the impacts the current tax policy settings have on Australia's competitiveness for capital, the effects they have on its cost, and whether the rules operate in a competitively neutral way between foreign based and Australian based multinational groups.

The frame of reference also needs to encompass:

- global and Australian markets and the prevailing economic conditions;
- the value chains of multinational groups;
- the multinational group's "economic footprint" in Australia;
- technological and environmental drivers impacting on business models, processes and profitability; and
- the coherence and effectiveness of Australia's tax laws in terms of their domestic and international operation.

When considering the stocks and flows of global and domestic capital it is important to be able to distinguish between funding flows directed to economic activities that are location-specific to Australia and financial flows that use Australia as a mere conduit or a base to fund economic activities in third countries. Such indirect flows can be channelled through Australia to create deductible interest expenses that reduce the amount of Australian source

[42] The World Bank, World Data Bank, GDP (current US$) Data, updated to 1 February 2017, website accessed 11 February 2017, shows Australian 2015 GDP at $US1.34 trillion compared to world GDP of $US74.15 trillion, representing 1.8% of global GDP. Page 4 of the Australian Trade and Investment Commission publication, Why Australia, Benchmark Report 2017 (included as Table 2 in the body of the paper) shows Australia as the 13 largest of the world economies accounting for 1.7% of global GDP.

income that is subject to tax[43]. To the extent that the data used for the national accounts does not distinguish between conduit financing and cases where debt is used for economic purposes in Australia as the end destination, or where Australia is the ultimate economic beneficiary of the activities conducted in such third countries, it is not possible to assess the economy wide implications of conduit or base country financing. However, detailed studies at the individual entity level may provide some insights as to the impacts on reported income, expenditure, profits, balance sheet position, cashflow and tax paid in Australia.

A systemic approach necessarily entails an examination of the inherent connections between Australia's overall economic and financial position at the macro level (which reflects the aggregated impacts of the positions taken by multinationals as a sub-demographic) and the micro level of individual multinational groups that have a significant economic presence in Australia. A practical rule of thumb in judging whether an entity has a significant economic presence would be the Australian Taxation Office (ATO) list published on data.gov.au of around 1900 entities included in its report of entity 2014-15 tax information.

To the extent the tax system creates a material additional bias in favour of debt funding or the allocation of financial risk over and above what would be achievable in the competitive market system (through the market mechanisms for determining creditworthiness, debt tolerance, solvency and arm's length dealing between arm's length parties), subject to the definitions adopted for debt and equity, the flowthrough impact on Australia's national accounts has the potential to create harmful economic distortions in terms of Australia's credit rating and country risk because of the economic significance of multinationals as a sub-demographic. For the reasons discussed below in relation to the internal as opposed to external debt funding options multinationals have, the bias in favour of debt funding largely relates (in terms of practical impacts) to the latitude foreign based multinationals have to adopt more debt-laden structures for their subsidiaries in Australia. This gives them a competitive advantage because the lower tax costs generated by higher levels of deductible interest expense result in higher after-tax levels of cashflow and profit and lower cost of capital. This competitive advantage could manifest in the ability to charge lower prices to increase market share or, subject to competition laws and foreign investment rules, in the ability to use a stronger credit rating to raise finance and buy competitors and run them more profitably due to the lower cost of capital. Subject to those same laws and rules, it also makes Australian assets and income flows more attractive to foreign takeovers, quite apart from any exchange rate advantage that may arise.

There is also a tax administration aspect that is relevant to Australia's perceived economic performance and financial standing as reflected in the national accounts. The existence of any material tax gap between the tax properly payable under the law and the tax actually collected could potentially affect Australia's financial profile as well as its fiscal position. In this regard the effectiveness of the tax administration becomes a strategic issue. It is therefore important that the ATO does everything it can to optimise the tax base for each taxpayer demographic, including the entire population of multinational groups, not just those selected for audit. Failure to do this opens up the possibility of competitive advantage for any multinationals that pay less than they should under the law, an advantage that is additional to any benefits a multinational group may be able to derive from tax policy settings that create a bias in favour of channelling debt into its Australian operations. Given the strong demand from Australian and Australian institutional investors like superannuation

[43] See section 25-90 of the *Income Tax Assessment Act 1997*.

funds and major charities residents for well performing stocks that pay franked dividends and the need for Australian based parent companies of listed multinationals to maintain a strong financial profile[44], it is possible that foreign based multinationals operating in Australia present a greater (but not the only) tax compliance and tax base erosion risk. The accountabilities, and public disclosure requirements associated with public listing may make Australian based multinationals a useful point of comparison with the profit and tax performance of subsidiaries and branches of foreign based multinationals and Australian based non-listed multinationals.

Debates about company tax rates and attracting foreign investment capital

The "Iceberg Model" is a useful diagnostic in terms of Australia's international positioning, a context in which there has always been a keen focus on Australia's competitiveness, the main emphasis in current debates being whether Australia can attract sufficient foreign investment capital to increase its rate of growth. The argument being advanced is not presently articulated in terms of the full range of factors currently affecting the allocation of global capital and Australia's advantages and disadvantages as a competitor for capital; it is based on the reasoning that a significant reduction in Australia's company tax rate, following the trend and intention in some other countries, will increase after tax returns on equity and thereby promote capital investment inflow, increase employment and increase returns to labour[45]. While the argument is not yet fully articulated in the public domain, it seems to necessarily entail the following assumptions:

- that the statutory rate of company tax is a key driver in the mainstream global allocation of patient investment capital;
- that tax rate reduction can increase business investment despite historically low interest rates not achieving that outcome;
- that there is no need for base broadening or adjustment to Australia's tax policy settings in other respects to improve the efficiency of capital and labour allocation within the Australian economy;
- that the global stock of investment capital (in particular direct as opposed to portfolio investment) is highly reactive to company tax rates;
- that there is currently a shortage of investment capital to support the growth of business operations in Australia;
- that there are no other revenue or cost efficiency measures available to multinational groups to protect and enhance their profitability;
- other (non-fiscal) economic policy settings are not available or less effective than a cut in the company tax rate in stimulating business investment and economic growth; and
- the increase in investment and growth in nominal GDP, and perhaps the reduction in imputation benefits and refunds and the consequent increase in personal income tax, or other sources of revenue will more than offset the revenue cost of substantially reducing the statutory rate.

[44] A strong financial profile is needed in order to optimise the group's credit rating and cost of funds which in turn optimises the group's returns to shareholders and share value. This is discussed in more detail later in the paper.
[45] Address by the Prime Minister of Australia, the Honourable Malcolm Turnbull, to the National Press Club, 1 February 2017, including the transcript of Prime Minister Turnbull's answer to the question from Mark Kenny from the Sydney Morning Herald and The Age in relation to whether cutting company taxes will lead to lower taxes for people, more jobs and better economic growth.

From a public policy perspective, it seems self-evident that tax rate relief should not be used as a tax subsidy to substitute for the management discipline required for ongoing real economic productivity gains, or to compensate for deficiencies in economic or industry policy. Revenue and cost efficiencies have a non-linear effect on company tax payments because all of the increased revenue or reduced expenditure should be reflected in the bottom line - unless tax avoidance strategies are implemented to maintain the group's level of company tax payments or its effective tax rate. Moreover, it seems hard to justify tax relief without understanding whether and to what extent the tax savings, as distinct from improvements in other policy settings and conditions:

- assist capital formation;
- promote economic growth;
- shelter economic rents from Australian taxation;
- produce higher after-tax rates of return over and above that necessary to justify business investment decisions according to accepted commercial principles (discussed below) and prevailing economic conditions;
- shift the tax burden to shareholders; or
- require compensating revenue raising measures.

It is also relevant to consider the appropriate balance between a desire to attract marginal investment that relies on lower tax rates in order to achieve commercial rates of return and the desire to establish general and neutral tax settings for the mainstream of business investment to promote strong and sustainable economic growth, the efficient allocation of capital and labour across the Australian economy, and sufficient, sustainable and equitable tax revenue flows.

The responsiveness of foreign investment and GDP to statutory tax rates

Australia's GDP has risen from $US394.2 billion in 2002 to $US1.56 trillion in 2014, then successive drops to $US1.46 trillion in 2014 and $US1.34 trillion in 2015[46]. Table 4 below (extracted from "Why Australia, Benchmark Report 2017", Australian Government, Australian Trade and Investment Commission) shows that Australia has been internationally competitive in attracting direct foreign investment despite the 30% statutory rate of company tax that has been in place since the 2001-02 year of income[47], attracting 2.2% of global direct investment compared to its 1.8% share of global economic activity.

[46] The World Bank Data, GDP (current US$) Data for Australia shows a strong underlying trend with GDP increasing at a significant rate from $US394.2 billion in 2002 to $US1.56 trillion in 2014, then successive drops to $US1.46 trillion in 2014 and $US1.34 trillion in 2015. Movements in the USD/AUD exchange rate also need to be taken into account.

[47] Australia's future tax system, Architecture of Australia's tax and transfer system, Commonwealth of Australia, August 2008, chart 4.2 at Page 193; New Business Tax System (Income Tax Rates) Bill (No 1) 1999, Schedule 2 reduced the company tax rate from 34% to 30% for 2001-02 and later years of income.

TABLE 4

TOP DESTINATION FOR FOREIGN DIRECT INVESTMENT

Australia remained one of the world's top destinations for foreign direct investment (FDI) stock in 2015, with a 2.2 per cent share of the global stock of FDI. Australia received US$537 billion in FDI in 2015, up from 34 per cent of GDP to 44 per cent of GDP between 2005 and 2015 on the back of continued economic expansion and integration with trading partners, particularly the Asian region.

AUSTRALIA'S SHARE OF WORLD FOREIGN DIRECT INVESTMENT STOCK, 2014–15

Region/Economy	FDI (US$ billion)		FDI (as % of GDP)		FDI (% of World Total)		% Change	% CAGR
	2014	2015	2014	2015	2014	2015	2014–15	2005–15
World	**25,113**	**24,983**	**31.8**	**33.6**	**100.0**	**100.0**	**-0.5**	**8.1**
Developed economies	**16,307**	**16,007**	**35.6**	**37.3**	**64.9**	**64.1**	**-1.8**	**6.5**
Developing economies	**8,172**	**8,374**	**26.9**	**28.5**	**32.5**	**33.5**	**2.5**	**12.3**
East Asia	2,886	3,089	22.5	23.2	11.5	12.4	7.0	12.9
South-East Asia (ASEAN)	1,707	1,705	67.6	69.9	6.8	6.8	-0.1	14.7
Transition economies	**634**	**601**	**22.7**	**31.2**	**2.5**	**2.4**	**-5.1**	**8.9**
USA	5,390	5,588	31.1	31.1	21.5	22.4	3.7	7.1
Hong Kong	1,507	1,573	517.4	507.4	6.0	6.3	4.4	12.3
UK	1,744	1,457	58.3	51.1	6.9	5.8	-16.4	5.5
China	1,085	1,221	10.4	11.1	4.3	4.9	12.5	16.2
Germany	1,090	1,121	28.1	33.4	4.3	4.5	2.9	5.8
Singapore	963	978	314.2	334.2	3.8	3.9	1.6	15.2
Switzerland	764	833	109.0	125.3	3.0	3.3	9.0	17.2
France	729	772	25.7	31.9	2.9	3.1	5.9	7.4
Canada	954	756	53.5	48.7	3.8	3.0	-20.8	1.7
Netherlands	716	707	81.3	95.8	2.8	2.8	-1.2	4.0
Australia	**563**	**537**	**39.0**	**43.9**	**2.2**	**2.2**	**-4.5**	**8.1**
Spain	592	533	42.8	44.5	2.4	2.1	-9.9	3.3
Brazil	615	486	25.5	27.4	2.4	1.9	-21.0	10.6
Italy	347	335	16.2	18.5	1.4	1.3	-3.3	3.5
India	253	282	12.4	13.5	1.0	1.1	11.7	20.6
Russia	284	258	14.0	19.5	1.1	1.0	-9.0	3.8
Indonesia	228	225	25.6	26.2	0.9	0.9	-1.3	18.5
Thailand	192	175	47.5	44.4	0.8	0.7	-8.7	11.1
South Korea	179	175	12.7	12.7	0.7	0.7	-2.6	5.2
Japan	172	171	3.7	4.1	0.7	0.7	-0.6	5.4
Malaysia	136	118	40.2	39.7	0.5	0.5	-13.4	10.2
UAE	100	111	25.1	32.2	0.4	0.4	11.0	15.0
Vietnam	91	103	48.9	53.7	0.4	0.4	13.0	16.4
Taiwan	70	72	13.2	13.8	0.3	0.3	3.5	5.3
New Zealand	77	66	38.7	38.3	0.3	0.3	-13.8	4.1
Philippines	57	59	19.9	20.3	0.2	0.2	4.7	14.8

Note: Totals exclude the financial centres in the Caribbean. **CAGR** = compound annual growth rate.

***Sources:** United Nations Conference Trade and Development (UNCTAD), FDI/MNE database (www.unctad.org/fdistatistics); Austrade*

SECTION 4 **LOCATION** / 43

Taking an even longer time series, the stock of net foreign investment (direct and portfolio) has increased from $A136.2 billion at the end of December 1988 to $A866.7 billion at the end of December 2014[48], despite the statutory rate of company tax ranging from 46% to 49% to 39% to 33% to 36% to 34% and then 30% over that period[49]. Looking at the current state of play, inbound foreign investment grew 8% in the year to 31 December 2015 to slightly over $A3 trillion[50].

One observation that can be made from this data is that in applying the "Iceberg Model" to understand why certain patterns and trends are occurring it is important to understand the component data sets that produce the final trend data since that trend is a combination of positive and negative impacts (in this case outbound and inbound investment). The relative weight and trending of the separate components and an understanding of what is driving the trends in the components gives a more insightful sense of the most probable net outcomes likely to unfold over time and the rate of change that can be expected.

While a fuller regression analysis is needed the lack of a headline correlation between company tax rates and net foreign investment suggests that multinational group investment decisions may be influenced by aspects of Australia's tax regime other than the 30% statutory rate, for example tax expenditures and offsets that reduce the effective rate, or a perception

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[48] ABS Statistics, Catalogue 5352.0, International Trade, Balance of Payments and International Investment Position, Australia, Sep 2016 (ABS website accessed 6 January 2017).

[49] Chart 4.2 page 193, Australia's future tax system, Architecture of Australia's tax and transfer system, Australian Government, The Treasury, August 2008.

[50] The level of foreign investment in Australia increased $220.5b (8%) to reach $3,024.4b for the year ended 31 December 2015 according to ABS Statistics, Catalogue 5352.0, International Investment Position, Australia: Supplementary Statistics, 2015 (accessed 4 November 2016).

that tax avoidance strategies and past dealings with governments and tax administrations will allow the group to achieve acceptable tax outcomes in Australia. In addition, non-tax factors may be more influential, like business opportunities in the Australian market or access to Australia's natural resources or skills base.

The nature and maturity of a group's operations are also likely to impact on the investment decision-making process. Major capital-intensive "greenfield" investment in Australia in the manufacturing, construction, mining, oil and gas sectors will raise different issues from the inclusion of Australia as a market for goods or services that are already being extensively marketed in other countries. In the second case the group will derive profits if it can sell its goods or services for more than the marginal cost of any additional production and any transport, marketing and distribution costs involved in expanding to Australia. Some goods like advanced electronic devices or pharmaceuticals may even command a price premium in Australia.

Any material increase over the current level of capital inflow would need to be planned and directed to strategically important areas where investment capital is needed for economic growth but is not currently being supplied by the market, and where corporate and institutional governance is strong. Without such a strategy and prudential oversight there would be risks of asset bubbles, further industry concentration, a reduction in economic efficiency and, potentially, the creation of a set of circumstances where an oversupply of capital makes it harder to ensure that the financial risks associated with placing that capital are properly identified and priced.

Shortage of foreign investment capital or lack of business investment opportunities?

However, the current climate of increased dividend payments[51] and the downward trend in business investment over recent years[52] suggests that corporate managers are not seeing the opportunities for investment, or perhaps sustained profitability, and are seeking to return surplus capital to shareholders, or support share prices. This is despite historically low interest rates (the Reserve Bank currently holding the cash rate at 1.5%[53]) and the inverse relationship between interest rates and investment that has traditionally been a cornerstone of economic theory. The Future Fund (which has a global investment portfolio) expects prospective returns to be lower than in recent times[54]. On 15 May 2017 the Treasurer, Scott Morrison and the Minister for Finance, Mathias Hubert Paul Cormann, issued the Future Fund Investment Mandate Direction 2017 to give guidance to the Future Fund Board of Guardians to adopt an average return of at least the Consumer Price Index +4 to +5 per cent per annum over the long term as the benchmark return on the Fund, determining an acceptable but not excessive level of risk based on the probability of losses in a particular year[55].

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[51] See for example Michael Pascoe's article, "Most companies are paying higher dividends", *Sydney Morning Herald*, Tuesday August 23, 2016.
[52] ABS Statistics, Catalogue 5625.0 – Private New Capital Expenditure and Expected Expenditure, Australia, Sep 2016 (Released 11.30am (Canberra Time) 01/12/2016; accessed 18 January 2017).
[53] Reserve Bank of Australia Statement on Monetary Policy, August 2017.
[54] **future**fund Portfolio Update at 31 March 2017, released on 27 April 2017.
[55] Future Fund Investment Mandate Direction 2017, 15 May 2017, pursuant to subsection 18(1) of the *Future Fund Act 2006* published on the Future Fund website.

While it can be accepted that it will increase EPS and ROE for shareholders in the parent company, it is not clear how a cut in the company tax rate will assist in filling the perceived vacuum in business investment opportunities despite historically low interest rates. This reticence in the market for further investment implies a need for government intervention to create a framework for economic growth and to drive that agenda.

In the current environment policy settings to drive regional development, innovative business and infrastructure investment might provide the needed stimulus for economic growth, which is arguably the strongest driver of tax revenue performance, thereby also assisting to relieve the current structural deficit. There seem to be many possible areas for investment, including education, health and aged care, communications, computer sciences, tourism, adding value to primary production, satellite research and technology, nanotechnology, energy and water management and security, transport systems, regional development and high speed corridors between cities and regions, defence industries, medical research and technologies.

The need for strategies that make economic growth the primary focus; using the favourable borrowing conditions to debt fund the creation of infrastructure assets rather than relying on low interest rates to promote consumer demand; and, the importance of promoting economic growth as the best way to address the structural budget deficit; and the need to get tax settings right to balance revenue needs with international competitiveness taking account of all the factors impacting on private investment (rather than simply reducing tax rates) were points made by Dr Philip Lowe, Governor of the Reserve Bank of Australia, in his appearance before the House of Representatives Standing Committee on Economics on 24 February 2017[56].

In considering the question of Australia's competitiveness for global capital and the responsiveness and rate of change in new business investment that might ensue from a lowering of Australia's company tax rate for multinationals it would be relevant to consider the extent to which economic activities are location-specific to Australia and supported by global demand or are truly mobile. Australia is still a relatively high GDP per capita market ($US60,070 in 2015)[57], making it attractive to foreign exporters. However, the increasing concentration of wealth combined with casualization and underemployment in the Australian workforce[58], historically slow growth in wages and a reducing employees' share of company profits are structural drivers that arguably unbalance the market capital system and create a limitation on consumer demand generally, a cause for reticence in business investment[59].

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[56] Pages 16-17, Proof Committee Hansard, House of Representatives Standing Committee on Economics, 24 February 2017, Reserve Bank of Australia annual report 2016. The full text of Dr Lowe's comments are set out in Appendix 2.

[57] World Bank Data, GDP per capita (current US$), website accessed 11 February 2017.

[58] Casualization and underemployment were discussed in the RBA appearance before the House of Representatives Standing Committee on Economics and reported at Pages 14 -15 of the Hansard reporting [Proof Copy]. The full text of the relevant exchanges are included in Appendix 3.

[59] Dr Philip Lowe in his appearance on 24 February 2017 before the House of Representatives Standing Committee on Economics endorsed this view in answer to a question from Mr Keogh reported at page 14 of the Proof Committee Hansard,

> "**Mr KEOGH:** That consumption growth drives a lot of the forecasted economic growth.
> Dr Lowe **:** It does. If people are not spending then firms do not want to invest. So if consumption growth is stronger then there is a greater appetite for firms to invest. I would say it is a restraining factor at the moment".

In his opening statement to the House of Representatives Standing Committee on 24 February 2017 RBA Governor, Dr Lowe, said,

> "the current high level of debt, combined with low nominal income growth, is affecting the appetite of households to spend, and we are seeing some evidence of this in the consumption figures. The balance that is required is to support spending in the economy today while avoiding creating fragilities in household balance sheets that could cause problems for the economy later on. This is also something we need to watch carefully."[60]

In relation to the impact these downward pressures on disposable income are having on choices between consumption and saving, Dr Lowe stated,

> "We think consumption growth is still going to be quite modest. In recent years, consumption growth has been faster than income growth, so the saving rate has been coming down a bit. We think that process has probably run its course, at least for the time being, because of this dynamic between debt and low wage growth. Households are not really willing to run down the saving rate. So we think consumption growth is going to be relatively modest but it is going to be strong enough to create ongoing demand and give firms enough confidence to invest."

According to the World Bank and the RBA the global economy is continuing to grow at a lower than average rate[61]. This softness in demand has implications for inflation and fiscal policy since revenue collections depend on the trend in nominal GDP.

The stocks and flows of exports and imports between Australia and other countries paint a general picture of the Australian economy as a net importer of goods and services, though there has been a significant improvement in the 2016 deficit of $13.66 billion compared to 2015 deficit of $37.06 billion[62].

The focus of industry and broader economic policy appears to be on economic efficiency, research and development (with some measure of tax incentives) and export market development, rather than import replacement and support for existing manufacturing.

Understanding the sources of Australia's competitive advantage

Quite apart from the potential for regional development and transport infrastructure to stimulate economic growth in the domestic economy and address important issues of housing affordability and urban congestion, Australia has significant mineral, oil, gas and primary production resources, measured on a global scale. It is well located and skilled in relation to the development of space industries. It also has many areas of great natural beauty and magnificent local produce. It is geographically close to the fast-growing Asian region but does not share land borders with other countries. It has well established tertiary institutions,

[60] Ibid at page 3.
[61] See World Bank Data, GDP (current US$), website accessed 11 February 2017 and the statement by Dr Philip Lowe, Governor, Reserve Bank of Australia, Monetary Policy Decision, 1 November 2016, Number 2016-27.
[62] ABS Statistics Catalogue Number 5368.0 – International Trade in Goods and Services, Australia, Dec 2016.

many with high international standing. Its research centres continually produce major scientific breakthroughs like Wi-Fi, the bionic ear, important vaccines, gene technology and automated production. These fundamentals and capabilities of the Australian economy and the patterns and trends depicted in the national accounts (though admittedly the data has some shortcomings) provide some insights into capital mobility and a starting point for distinguishing between economic activities that are location-specific to Australia and those that are truly mobile.

Arguably, for example, there is no need for tax incentives to attract investment if the relevant activity depends on ongoing marketing and distribution of high value technologies and products to significant Australian customer bases, potentially at a price premium, thereby increasing the revenue and capital efficiency of offshore producers. Nor where it depends on the exploitation of Australian oil, gas and mineral resources for which there is global demand and already significant tax system support (for example, through the immediate tax deductibility of exploration expenditure that is capitalised for accounting purposes, research and development allowances, capital allowances that exceed accounting amortisation and depreciation and debt funding concessions for foreign and flow through investment). In both these cases company tax draws back less than one third of the economic rent in cases where rising prices and productivity improvements are driving profitability; the groups will still be making higher post tax profits despite the 30% statutory tax rate, even higher if they engage in tax avoidance. Despite the growing accounting profits tax incentives can cause a significant lag in company tax revenues, an aspect that emphasises the importance of ensuring that in so far practicable the tax system can operate in real time alignment with the underlying economic performance at the firm level.

Do Australia's tax rules give foreign based multinationals a competitive edge?

At another level, it would be worth considering the role of competition in ensuring the efficiency and sustainability of the market capital system and the promotion of real economic growth. The natural advantages larger enterprises have over smaller rivals in terms of market power, economies of scale and cost of capital advantages can cause serious economic distortions with the potential to adversely impact economic efficiency and promote monopolistic behaviour and rent taking. This can affect Australia's attractiveness to foreign investment because pricing decisions made by entities with inordinate power and strength in bargaining can flow through to the wider economy, driving up the costs of end users and businesses that need those higher priced inputs for their production.

Quite apart from issues arising from the concentration of multinational group participation within Australian industry sectors, reflected in the concentration of income amongst the large businesses depicted in the ATO's 2013-14 and 2014-15 reports of entity tax information, some of which is no doubt driven by the relatively small size of the Australian economy (estimated by the World Bank at 1.8% of global economic activity in 2015[63] and by Austrade at 1.7% in 2017[64] (see Table 5 below)), tax policy settings and tax avoidance can create competitive biases in favour of foreign based multinationals. Any such distortion seems

[63] The World Bank, World Data Bank, GDP (current US$) Data, updated to 1 February 2017, website accessed 11 February 2017, shows Australian 2015 GDP at $US1.34 trillion compared to world GDP of $US74.15 trillion, representing 1.8% of global GDP. Australia is ranked the 12th largest economy out of 217 countries based on data for comparative GDP for 2015.
[64] Why Australia, Benchmark Report 2017, Australian Government, Australian Trade and Investment Commission, page 4.

inconsistent with the design focus of Australia's company tax regime, which is generally intended to allow Australian based and foreign based multinationals to competed head to head in Australia and overseas markets with only the source country tax rules applying in each jurisdiction.

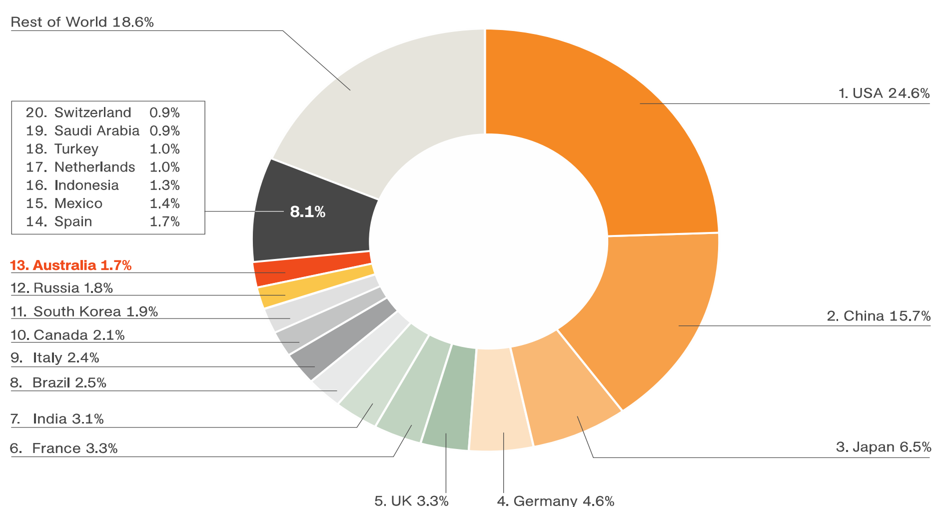
TABLE 5

WORLD'S 13TH LARGEST ECONOMY

Global forecasts predict Australia will maintain its position as the world's 13th largest economy (in US dollar terms) in 2017. Australia's nominal GDP is estimated at US$1.3 trillion (A$1.7 trillion) and accounts for 1.7 per cent of the global economy. Australia has almost tripled the value of its total production from two decades ago.

WORLD'S 20 LARGEST ECONOMIES – 2017[F]

Percentage share of total world nominal GDP in US$



F = Forecast
GDP of the world's 188 economies: **US$78,914 billion**
GDP of 20 largest economies: **US$64,270 billion (81.4% of world's GDP)**
GDP of ASEAN–10 economies: **US$2,754 billion (3.5% of world's GDP)**
Sources: International Monetary Fund, World Economic Outlook Database, October 2016; Austrade

SECTION 1 GROWTH / 4

Further policy consideration should be given to the practical operation of Australia's thin capitalisation regime[65]. Moreover, the tax deductibility of funding costs associated with conduit financing through Australia of third country investment also creates a tax shield for Australian source income streams that would be subject to tax in the absence of such arrangements[66]. These are discussed in more detail below.

Since tax avoidance can create an unfair competitive advantage by either reducing the amount of company tax that should be paid on profits relative to that paid by peers or by generating a subsidy where the tax cost has been borne by customers or labour rather than the ultimate shareholders, the ATO has a pivotal role to play in ensuring in so far as the legislative design allows that the company tax regime operates in an even-handed way in

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[65] Division 820 of the *Income Tax Assessment Act 1997*
[66] See section 25-90 of the *Income Tax Assessment Act 1997.*

relation to foreign based and Australian based multinational groups. This can only be judged by transparent reporting of the effectiveness of the ATO's compliance activities in relation to multinational groups. The nature and extent of the compliance coverage of multinational groups, the value of tax risks identified each year and in the total risk pool, the comparison of voluntary company tax payments and additional collections obtained through compliance activity in respect of each year of income, the relative tax performance of Australian based and foreign based listed and privately held multinational groups, analysis of taxpayers in loss and tax gap analysis all help to inform assessments of ATO effectiveness.

Distinguishing increases Australia's capital stock from foreign takeovers and restructures

Any policy settings designed to make Australia more attractive to foreign investment should draw a distinction between foreign investment that creates new assets and operations and investment related to the acquisition of existing Australian assets and operations[67]. While in some cases such takeovers may give rise to tax liabilities for some of the vendors in respect of any capital gains, one potentially negative side effect can be the use of debt funding to increase the gearing of the existing assets and operations above their present level. Of course, a multinational can restructure its Australian operations to increase its leverage without a change occurring in the underlying ownership. An example of increasing the leverage of an Australian business following a change of ownership to reap significant tax benefits, while structuring the financing arrangements to ensure the interest is not taxable, is reported at paragraphs 141 and 165 of Robertson J's judgment in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092.* The consequence is that the new owners benefit from the fact that more of the existing profit stream is shielded from Australian tax[68], making these profit streams cheaper in after-tax terms in the context of foreign takeovers. These tax benefits increase the after-tax rate of return the foreign investors get from those existing businesses, making Australian businesses more attractive to foreign buyers and potentially placing Australian competitors at a disadvantage. There is also a revenue cost to these debt financing concessions and the question is whether that is overly generous in terms of attracting foreign investment, an issue that is also relevant to start ups.

The participation of multinational groups, including industrials and financial institutions, in global capital markets and the operation of the internal capital market within each of those groups are discussed below.

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[67] This distinction was raised by the former Reserve Bank of Australia Governor, Dr Glen Stevens, in an exclusive interview with T*he Australian* and the *Wall Street Journal*, reported as a front page story in the August 17, 2016 edition of *The Australian*.

[68] This is likely is where the target Australian business is a publicly listed industrial company which has set its level of debt funding to optimise its credit rating and minimise its cost of funds. New foreign owners may seek to take advantage of the debt funding tolerance reflected in Australia's thin capitalisation provisions (section 820-195 of the *Income Tax Assessment Act 1997*). Australia previously had rules restricting the ability to increase the gearing of existing assets (the former Division 16G of Part III of the *ITAA 1936*) which were repealed by section 4 of Part II (Consequential and other amendments) of the New Business Tax System (Thin Capitalisation) Act 2001, the design of which placed all the work of controlling thin capitalisation on the new Division 820 of the *Income Tax Assessment Act 1997* which then contained a generous debt/equity ratio of 3:1 (now 6:4). It was forecast that the 2001 thin capitalisation measures would be revenue positive:

2001-2002	***2002-2003***	***2003-2004***	***2004-2005***
$10 million	$395 million	$350 million	$350 million

Balancing revenue needs with the use of tax policy for wider social or economic objectives

Tax policy settings as a feature of the current global and domestic environment should seek to strike an appropriate balance between Australia's revenue requirements and the furtherance of any broader economic or social objectives that may be able to be influenced through the tax system. Ideally, tax policy settings should be broadly neutral between Australian based and foreign based investors. However, there may in some situations be a need to make some level of concession to optimise Australia's position in relation to attracting global trade and investment should a systemic analysis confirm that such an approach is necessary and that the use of tax policy is the most appropriate means. In seeking to maintain this (shifting) balance point it is essential to first identify and distinguish between the different impacts caused by pre-tax economic factors, tax policy settings and those caused by tax avoidance (whether contrived arrangements to technically avoid the operation of the tax law or arrangements that take advantage of any loopholes or lack of coherence in the tax law).

It seems inevitable that the inherent complexities of global business have to be accurately reflected in the design of the tax rules applicable to multinational businesses if those rules are not to overreach and distort markets - or create tax avoidance opportunities or unintended benefits. This inevitability derives from the reality that multinational groups' business objectives, including their desired pre and post-tax rates of return, and the interests and tax attributes of their ultimate shareholders will drive the behaviour of multinational groups in ways that may impact positively and negatively on Australia's company tax system. (This seems especially likely when the group's business objectives are built into the key performance criteria and remuneration arrangements of senior group management.) It makes the alignment between the tax rules and the competitive market system a strategic issue. It also raises questions as to what is realistically achievable in the context of voluntary compliance (which clearly has a role) relative to active supervision and enforcement, a balance that has to be reached on a sound analytical basis that is reflective of the real drivers of multinationals' behaviour.

Chapter 3: Law design and compliance management for a viable company tax base

This Chapter explores the application of the systemic analysis framework to evaluate the effectiveness of the current company tax settings and administrative approaches in achieving revenue collections commensurate with the economic rewards that multinational groups are obtaining through their Australian operations. It also explores whether the different parts of Australia's tax laws fit together properly to form a coherent taxation framework.

The Chapter applies the systemic analysis framework to identify the key drivers of attitudes to tax compliance and explores whether the framework can assist in determining whether tax avoidance structures are effective.

Responsibilities and remuneration of group managers can impact risk to Australia's tax base

Tax strategies are matters for decision by the senior management of multinational groups and the optimisation of the group's tax position will often require global structures and approaches. The payment of company tax may have differing impacts on the thinking of group managers and the shareholders of the ultimate parent company. The attitudes of foreign shareholder classes to paying tax in Australia will be driven by their tax status and the tax rules and tax rates in their home country; while they would obviously welcome higher after-tax returns from their corporate investments they still have to consider what impacts those higher returns will have on their obligation to pay tax in their capacity as shareholders. They may be entitled to some form of tax relief to prevent economic double taxation (a result that is achieved for Australian resident shareholders of Australian companies through the imputation system discussed above).

However, foreign group management are more likely to be generally averse to paying company tax and prefer tax to be levied on company profits at the shareholder level. This would maximise profits at the company level, and hence share value, both of which are key performance indicators for senior management. However, shareholder level taxation as a substitute for company taxation would seriously jeopardise Australia's ability to tax the profits derived from foreign direct investment. It would also create indefinite deferrals of tax revenue flows to the extent company profits were accumulated. Imputation benefits will be a factor in the attitudes of the managers of Australian based multinationals, but those attitudes could vary depending on whether or not the particular multinational is listed on the stock exchange, its shareholder demographics and whether its shares are positioned in the market as a capital investment or income flow stock.

It needs to be recognised that the financing and taxation functions within a multinational group are very closely connected. Group Finance Directors, Chief Financial Officers and Tax Managers will invariably have regard to the most tax efficient way of doing business and providing funding. Management and shareholders will have regard to both pre and post-tax rates of return as critical measures of success. It may be that the group tax manager and local delegates have performance indicators specified in terms of target effective tax rates, the identification of strategic tax planning opportunities, as well as compliance assurance and the effective advocacy of the group's interests in the design of new policy and of compliance strategies and processes by the tax administration.

Multinational groups have enormous flexibility in structuring their global operations

The framing of robust legislative rules to implement tax policy settings needs to be mindful of the enormous flexibility multinational groups have to adapt their global structures, funding channels and related party dealings to take advantage of differing tax policy settings between countries and to position themselves to anticipate and neutralise the impacts of proposed changes to the law. Media commentaries show they are active participants in (and sometimes instigators of) tax policy debates, proactive in advocating their special interests and may even be directly involved in the shaping of any ensuing legislation. This is unsurprising given they are legitimate stakeholders and will have responsibilities for managing tensions between tax impacts and the groups' investment goals for their shareholders.

Added to this, innovations in financial engineering have enabled the bifurcation and restructuring of traditional financing transactions and the creation of hybrids and synthetics for debt, equity and a whole range of innovative financial instruments and arrangements (for example "straddles", mezzanine finance and sale and leaseback arrangements). These tools may be able to be used in tax efficient financing and tax avoidance arrangements. For example, it is possible to construct a "straddle" between different members of the same multinational group for just about any financial arrangement, where offsetting negative and positive positions are created as part of a zero sum game, the profitable part being engineered to occur in a low or no tax jurisdiction and the corresponding loss in the high tax jurisdiction.

This is not to say that all corporate and financial structuring is necessarily driven by an intention to avoid Australian tax; some aspects of global legal structures may be a means of marshalling global funding sources, creating channels to meet cashflow requirements in other jurisdictions, increasing revenue or cost efficiency, or for managing financial risks. However, these structures can have negative impacts on Australia's tax take regardless of the dominant purpose behind them. It is for this reason that in the context of non-arm's length commercial or financial relations the operation of Australia's transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997* and in Australia's tax treaties are ***not*** predicated on the existence of a tax avoidance purpose; if non-arm's length conditions operate in the context of commercial or financial relations between onshore and offshore parties and cause Australian profits to be less than would accrue under arm's length conditions, tax adjustments can be made[69].

Ensuring different parts of Australia's tax laws relevant to corporate financing are coherent

Division 974 of the *Income Tax Assessment Act 1997* dealing with the definitions of "debt" and "equity" for tax purposes prescribe detailed sets of attributes and exceptions that are not expressed as basic principles reflecting the nature of the respective economic risks being assumed by the provider and user of the capital, despite the intention of those provisions being to introduce definitions based on economic substance rather than legal form. Under the current law financial engineers can construct instruments that selectively meet the statutory definitions and thereby maximise tax deductibility and non-assessability in relation to corporate financing transactions and structures. While the thin capitalisation provisions place upper limits on debt deductions the current statutory safe harbours are likely to allow higher levels of debt funding on the Australian side than would be achieved in lending arrangements between independent parties dealing at arm's length with each other. While the transfer

[69] Division 815 *Income Tax Assessment Act 1997.*

pricing rules require an arm's length interest rate to be used[70], that rate is required to be applied to the higher level of debt permitted by the thin capitalisation rules.

The effectiveness of profit shifting strategies is determined by their economic substance

The shaping of tax legislation also needs ensure that the aggressive use of tax competition by some countries who establish themselves as tax havens or highly concessional regimes does not allow the shifting of profits generated by economic activity in Australia to those jurisdictions without those jurisdictions having to ***earn*** those profits in an economic sense. The statement of the object of Subdivision 815-B in subsection 815-105(1) of the *Income Tax Assessment Act 1997* can be seen as a legislative intention of ensuring that commercially rational analysis and the economic tension that exists between independent parties dealing at arm's length to protect and further their separate economic and financial interests guides the application of Australia's transfer pricing rules. It is aimed at ensuring the amount brought to tax in Australia from cross-border conditions between entities is not less than would be the case if the conditions reflected the arm's length contribution made by the Australian operations through functions performed, assets used and risks assumed and the conditions that might be expected to operate between entities dealing at arm's length.

Effective policy implementation therefore requires that the ATO has the ability to discern between arrangements involving mere churn, conduit arrangements or the rebooking or nominal relocation of activity and assets on the one hand, and real economic activity that generates profits and creates valuable assets on the other. It also requires that the ATO has sufficient resources, expertise and the compliance strategies needed to ***effectively*** cover the multinational group taxpayer sub-demographic. The answers to these implied questions have to be based on reliable metrics, providing evidence that the ATO is in fact optimising the company tax base according to the law.

The structuring flexibility that multinational groups possess can result in legal structures that are far more complex and costly than can be explained by reference to the structures and processes needed to efficiently conduct the relevant business operations. It follows that economic functional analysis and economic productivity analysis, both of which are explained below, are important tools for distinguishing economic drivers from tax avoidance drivers - and from other non-economic drivers of business structures and processes which may present risks from the perspectives of corporate governance and moral hazard.

Economic functional analysis examines the economic functions performed, the assets used and risks assumed within each jurisdiction. It is based on the contribution these elements would be expected to make to the profitability of the operations conducted in each jurisdiction, judged by reference to the behaviour of independent parties dealing wholly independently with each other. For example, the analysis distinguishes between churn, re-invoicing and conduit activity on the one hand and the generation of real economic value that, on the basis of dealing between independent parties dealing at arm's length, would be reflected in profits.

Economic productivity analysis examines the relationship between business inputs and outputs, the drivers of costs and revenues for a particular business, and the relationship between revenue efficiency and cost efficiency. Financial ratio analysis supports this

[70] Section 815-140 of the *Income Tax Assessment Act 1997*.

process. To be reliable, the analysis has to have regard to the economic context in which the examined business finds itself as well as the economic and business outlook.

From a policy perspective, in practical tax administration, and to manage tax risk, it is vital to develop a realistic sense of the extent to which aggressive tax competition is capable of shifting the location of real economic activity - as opposed to being a catalyst for increased tax planning. For example, re-invoicing or conduit arrangements[71], stripping valuable intangibles created by Australia and licensing them back[72] or allocating an inordinate amount of financial risk and no margin to Australia[73] purport to reduce taxation by artificially shifting profit from Australia without altering the fundamentals of how the global value chain and

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[71] See *San Remo Macaroni Company Pty Ltd v FC of T* [1999] FCA 1468 which is an example of a global strategy to interpose a Swiss corporation, Bigalle SA, controlled by an accountant, between the Italian manufacturer and the Australian buyer to increase the price paid by the Australian buyer. The taxpayer challenged the validity of certain determinations made by the Commissioner. In considering the question of whether Bigalle SA and San Remo Macaroni Company Pty Ltd were dealing with each other at arm's length Hill J stated at paragraph 62 of his judgment:

> "It was clearly open to Mr Read (the taxation officer) on the material before him to form the view as he did that San Remo and Bigalle were not dealing with each other at arm's length, even if San Remo had no direct financial interest in Bigalle. The fact that Bigalle appeared to be owned and controlled by an accountant, the circumstances of its incorporation, the fact that no attempt was made to renegotiate prices as the Swiss franc appreciated and that what may have been some of the profit to Bigalle was repatriated to San Remo by way of loan all pointed to this conclusion. These facts pointed also to the conclusion that really all that was happening was a reinvoicing arrangement."

[72] See *FC of T v Noza Holdings Pty Ltd & Anor* [2012 FCAFC 43; 2012 ATC 20-313 which is an example of a global strategy to consolidate the holding of group intangibles.

[73] See *SNF (Australia) Pty Ltd v FC of T* [2010] FCA 635; 2010 ATC 20-190 per Middleton J and on appeal as *FC of T v SNF (Australia) Pty Ltd* [2011] FCAFC 74 per Ryan, Jessup and Perram JJ. The Australian taxpayer company was a marketing distributor of physical products, flocculants, on behalf of its French parent company for use in mining, paper manufacturing and sewerage treatment. It made persistent losses which the Commissioner argued were due to the prices the Australian company was paying for supplies of products. The taxpayer adduced evidence that the Australian company was paying the same or lower prices to those the suppliers charged to independent buyers. The allocation of the marketing distribution role to the Australian taxpayer was not considered in the light of the way the case was argued between the parties. The question of whether Australia's tax treaties as enacted in Australian law were a separate head of power for transfer pricing adjustments was not argued on the assumption that, despite the different wording, the result would be the same as that flowing from an application of Division 13. Following the appeal decision on 1 June 2011 Subdivision 815-A of the *Income Tax Assessment Act 1997* was introduced in *Taxation Laws Amendment (Cross-border Transfer Pricing) Act No 115 of 2012* which received Royal Assent on 8 September 2012, to confirm with retrospective effect for income years starting on or after 1 July 2004 (section 815-1 of the *Income Tax (Transitional Provisions) Act 1997)* that Australia's tax treaties are a separate head of power for transfer pricing adjustments. Division 13 was later replaced by Division 815, Subdivisions 815-B, C and D, inserted by the*Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act No 101 of 2013* which received Royal Assent on 29 June 2013. It superseded Subdivision 815-A for income years starting on or after 1 July 2013 (section 815-15 of the *Income Tax (Transitional Provisions) Act 1997).*

Australia's role as part of it operate in a real world business sense. If in a given case the only change in the consolidated accounts of the ultimate parent company of a multinational group following a restructure of its global operations is a reduction in tax payable in Australia, without any material change in Australian operations, it would be difficult to argue that the purpose and effect of the restructure was to improve pre-tax economic productivity. Absent compelling contrary evidence it would be logical to conclude in such a case that the demonstrated effect achieved was the purpose and object of the restructure.

Where real economic activity is able to be transferred from Australia to another country, it has to be determined whether an independent party would seek economic compensation for such a transfer. It would also need to be determined what level of profit should be reallocated from Australia to the country now performing that economic activity; whether the activity is of a nature for which independent parties dealing wholly independently with each other would pay a basic or higher rate of return. [74]

The use of the systemic analysis framework to analyse global businesses helps demonstrate that many tax avoidance structures that rely on creating the appearance that profits arise in a low tax jurisdiction, rather than in the country where they are really earned and have their economic source, are ineffective.

A strategic approach to legislative design and feedback loops to ensure ongoing effectiveness

In view of the complex and dynamic nature of the environment itself, and the added possibility that tax planning structures will mutate in response to or in anticipation of tax law changes, Australia's tax policy settings need to be under continual review so that they remain relevant, efficient and robust. This is feasible only if:

(i) the policy objectives are able to be discerned with reasonable clarity from the relevant taxation provisions and explanatory material (should recourse to the explanatory material be necessary and appropriate);
(ii) the stated fiscal policy can and in fact does causally impact the underlying drivers and dynamics it seeks to influence, including any current behaviours and likely behavioural responses; and
(iii) the fiscal policy objectives and any associated revenue costs are capable of reasonably accurate measurement[75].

Taking a truly strategic approach to fiscal policy settings necessarily extends to adopting a legislative design process that ensures the laws will be administrable by taxpayers, the ATO

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[74] The issues regarding compensation for restructures and the level of profit to be transferred are discussed at some length in Part II: Arm's length compensation for the restructuring itself, of Chapter IX, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, July 2010.

[75] It is relevant to note that Chapter 12 of *Australia's future tax system* (Henry Review) includes recommendations along the following lines:

> that a principles based approach to law design be adopted to reduce volume and complexity and assist interpretation that is consistent with the policy objectives (Recommendation 112); five yearly reports on the overall performance of the tax and transfer system, including estimates of efficiency costs and distributional impacts (Recommendation 132); and independently developed reporting standards to identify and measure tax expenditures, including a basis for reporting their broader economic and distributional effects (Recommendation 137).

and the courts - and will be robust against tax avoidance. The challenge in such a design process is to ensure all stakeholders have an effective voice but that no group has undue influence. A strategic approach also necessitates a feedback loop; an ongoing evaluation of whether the observed behaviours of multinational groups within the Australian tax system (as reflected in their economic, financial and tax performance) align with the intended policy outcomes. It also requires the ability to make strategic responses in a timely way if the observed behaviours do not measure up to the policy intent.

Tax policy no substitute for policy levers directly impacting the structural drivers and dynamics

Given the primary purpose of the tax system to define the tax base and set rates in order to raise tax revenue consequential on the derivation of net income, profits or gains by the entity subject to taxation, it seems self-evident that tax policy settings operate indirectly (with debateable precision) in relation to the pursuit of non-revenue objectives. They can never be a substitute for other levers of social and economic policy that may be able to directly influence the relevant structural drivers and dynamics. Income tax (including company tax, royalty and interest withholding tax) is based on what the law defines as the corporate tax base (after any exemptions, concessions or tax credits) and the applicable tax rates. In some important respects the impacts of the various determinants of the final tax payable may not be transparent and can fall unevenly on different industry sectors. The evaluation of tax laws and the determination of fiscal policy settings therefore needs to have regard to not only nominal statutory rates of tax but also effective tax rates, which are impacted by tax expenditures, legislative loopholes and tax avoidance. Where sound estimates are not available for the revenue impact of tax rate movements, tax concessions, loopholes or the impact of tax avoidance on the various industry sectors and ownership demographics, governments are not in a position to optimise Australia's tax base by appropriately balancing revenue objectives and any broader policy objectives.

Understanding the structural drivers and dynamics shaping current economic conditions

Apart from the tax rules themselves and the quality of the tax administration, the performance of the tax system will be significantly impacted by broader economic conditions and the relative revenue and cost efficiency of individual firms. The structural drivers and dynamics affecting: the demand for consumable goods and services; business investment (including from private savings); government expenditures; job creation and employment participation are all important connected frames of reference. They all have a bearing on economic system performance, in evaluating how well the social security safety net is working, in assessing the effectiveness of economic stabilizers, and in understanding the performance of the tax base. It could reasonably be argued that the performance of the Australian economy is the biggest driver of company tax performance. The extent of the correlation between company tax collections and the performance of the Australian economy is therefore and important touchstone in evaluating the performance of Australia's company tax system. However, as discussed in Chapters 8, 9 and 11, there are data reliability issues that need to be managed when undertaking this analysis.

Chapter 4: Factors driving business investment and how it is structured

Can tax policy settings materially impact on Australia's ability to attract new investment? What effect would a reduction in the rate of company tax have in this regard? In terms of the stock and flow of new investment into Australia by multinational corporations, the range of influences could reasonably be expected to include:

- whether an investment in Australia is consistent with the group's strategic directions, would make a strategic fit with current asset holdings and operations, and would align with the group's business model;
- economic conditions within Australia and the relative strength of the Australian economy (see Table 4 below[76])
- the availability of attractive business opportunities in Australia having regard to its natural resources, its standard of living and disposable incomes, competition regulation and dynamics in Australia (including barriers to entry and exit), and the expected costs and returns;
- the nature and extent of the financial and business risks associated with prospective investments in Australia and whether those risks are manageable;
- the financial capacity of the group and the relative merits of a potential Australian investment compared to other available options;
- the functions within the global value chain that would be performed in Australia;
- the amenity of Australia as a place to live and conduct business;
- the potential for the development of innovative products and services that may be exploited in Australia or elsewhere, as well as any opportunities to develop Australia's natural resources;
- the skills, inventiveness, research capability and learning potential of the available and future workforce and opportunities for collaboration;
- the extent and quality of Australia's existing infrastructure and whether strategies to enhance Australia's potential are being actively identified and pursued;
- fundamental political stability and social order within Australia;
- protection of property, rule of law, impartial dispute resolution and workable certainty regarding the laws affecting business;
- the relative risk profile of Australia compared to economic, social and political factors globally;
- the efficiency of Australia's financial system;
- the availability of capital for use in Australian ventures;
- Australia's trade, investment, financial market and political connections to the rest of the world and the potential they may create;
- the potential rates of return in Australia for capital and labour relative to other countries, including whether there are any opportunities to enhance capital efficiency, or obtain premium prices, economic rents, subsidies or windfall gains; and
- the key structural features of Australia's tax system, the effective tax rate they produce relative to the statutory rate, whether the tax liabilities of the

[76] Why Australia, Benchmark Report 2017, Australian Government, Australian Trade and Investment Commission, page 5.

> multinational group are likely to be borne by capital, could be offset by cost reductions to protect margins or can be passed on to consumers. All of these aspects are relevant to calculating the after-tax return to shareholders and whether that rate of return meets the group's internal hurdle rate. A useful reference point in this regard is the WACC for listed public companies since it reflects the rate of return needed to satisfy their shareholders and lenders[77]. (However, since WACC is an after-tax calculation care would need to be taken to examine how the cost of equity is impacted by tax rates, policy settings and previous tax avoidance.) The significance of the WACC is discussed in detail in Chapter 5. There may be additional consideration given to whether the group can further manage its Australian tax position and what opportunities might exist for tax minimisation, arbitrage or subsidies.[78]

Table 6 below shows that on average over the last 24 years Australia's economic conditions have been conducive to economic growth as a basis for attracting foreign direct investment. While the use of averages of this kind can obscure current economic performance and rate of change in economic conditions in individual countries like Australia, and the uneven influence that global economic conditions can have on particular countries, it may provide some level of confidence to investors looking at the middle to longer term in relation to business opportunities and economic management. However, there are also signs that there has been a tightening of business opportunities in Australia, and in many other countries, that foreign investors are likely to see as significant. Forecasts and extrapolations can more confidently be undertaken where the systemic analysis has been done to identify: the structural drivers and dynamics affecting Australia's current level of economic performance; the rates of change in key stocks and flows across the economy; and the acceleration or deceleration in those rates of change. That said, like in the case of the modelling done to support capital investment decisions by multinational groups, optimistic and pessimistic scenarios need to be developed to test the predictions and to create flexibility, responsiveness and resilience should the favoured scenario not eventuate.

Where a multinational group has existing investment in Australia it has to assess whether incremental investment would be beneficial and rank above other investment possibilities. The existing investment would be regarded as a "sunk cost" and the analysis would tend to focus on the return on the incremental investment, though some interesting questions may arise regarding the attribution of synergies if the new investment relies on or extends existing business infrastructure or operations. A number of factors outlined above in relation to an initial investment in the Australian market would also be relevant to incremental investment decisions.

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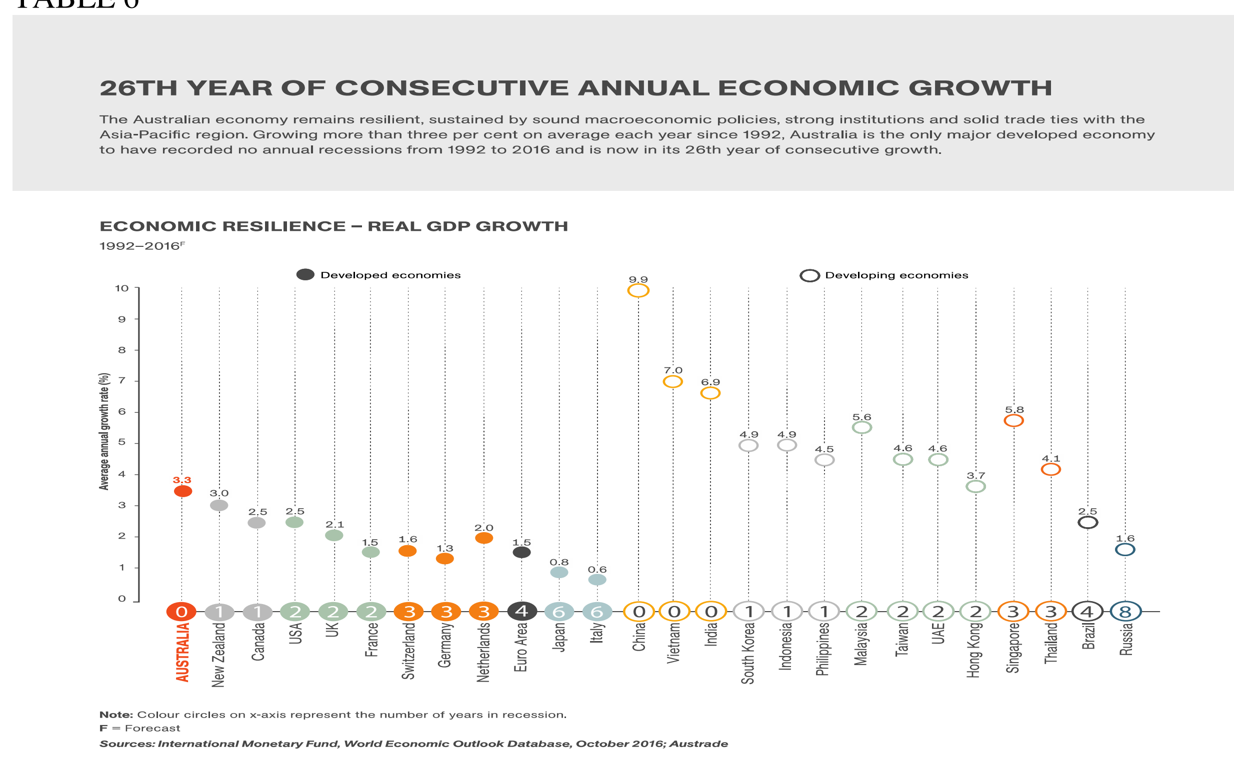
[77] See page 470 Fundamentals of Corporate Finance, Ross, Westerfield and Jordan (McGraw-Hill Urwin 7th Edition Alternative Edition) where the authors state,

> "a firm's overall cost of capital will reflect the required return on the firm's assets as a whole. Given that a firm uses both debt and equity capital, this overall cost of capital will be a mixture of the returns needed to compensate its creditors and those needed to compensate its stockholders."

[78] The issue of the connection between company tax rate settings and foreign investment was discussed by the House of Representatives Standing Committee on Economics with RBA representatives at its hearing on 24 February 2017 (Pages 6 and 11-13 of the Proof Committee Hansard). Those discussions (set out in full in Appendix 4 to this paper) reflect the RBA view that taxation is one of several factors impacting on foreign investment.

Commercially rational shareholders are interested in the after-tax rate of return they will get from their investment. On their behalf, the board of directors of the parent company aim to ensure that any investment will be worth more than it costs. The commercially rational investor will want to ensure as far as practicable that an investment will be likely to yield a return of the investment capital within a reasonable period (sometimes referred to as "the payback period" and reflected in times earnings ratios). Such an investor will also expect that a prospective investment is likely to make a margin that has regard to the time value of money and is commensurate with the financial risk associated with the prospective investment, risks that will be assumed only if the investor has a commercially rational basis for believing they are manageable and not excessive[79]. It is to be expected that, consistent with established industry practice, estimates of future cashflows and rates of return will be subjected to detailed examination as to the reliability of the assumptions on which they are based.

TABLE 6



It would be reasonable to expect that an investment decisionmaking analysis would also have regard to the group's financial capacity, funding options, the time value of money and the group's WACC.

The business investment risk arises because there is no guarantee that the estimates and forecasts will turn out to be correct. Unforeseen circumstances may arise that are beyond the control of business managers. Shareholders may lose some or all of the value of their equity interests. To minimise this risk commercially rational investors tend to undertake sensitivity analyses on the critical assumptions. For example, they might consider what the outcomes

[79] The methodologies are explained with detailed examples in Chapters 5 and 9 of Fundamentals of Corporate Finance, Ross, Westerfield and Jordan (McGraw-Hill Urwin, 7th Edition, Alternative Edition).

would be if the cashflow were lower because the market price of their product or commodity fell by 10% or 20%; if the construction of planned new facilities took a year longer to complete; or demand for the product fell by 20% or 40%; or a cheaper substitute for their product entered the market. It would make commercial sense to model optimistic scenarios as well where market analysis provided a sound commercial basis, for example where the underlying drivers indicate demand for the product or commodity is likely to increase, or new products needed or wanted by customers were in development, before forming a judgment on the most likely scenario. Commercially rational investors would also be likely to have regard to foreign exchange, interest rate and inflation risks.

The capital investment process involves the discounting of the projected cashflows to arrive at a net present value (NPV) for those cashflows. The cashflow forecast for each year of the investment is discounted for the period between the date of the investment and the date the particular cashflow is received, using the required rate of return as the discount factor. Each discounted cashflow is then aggregated to determine the NPV. An example of this process and how the discount factor is used in the formula is set out on pages 264-265 of Fundamentals of Corporate Finance, Ross, Westerfield and Jordan (McGraw-Hill Urwin, 7th Edition, Alternative Edition). The NPV of the cashflows is then compared to the cost of the investment. A positive difference identifies an acceptable investment and a negative difference shows the investment should be avoided. Where two investment prospects have positive NPVs but the group can only fund one, all other things being equal the prospect with the higher NPV would be chosen on the basis that it would have a larger positive impact on EPS and ROE.

The forecast payback period for investments may be done on an accounting basis or on a discounted basis that takes account of the time value of money by allowing for the return that the investment capital would make if invested elsewhere. While knowing the payback period is useful (since market and financial risks may increase the longer the investment horizon and funding implications would have to be considered) the adoption of an arbitrary cut off of a certain number of years biases investment decisions in favour of shorter-term liquidity and away from potentially high value longer term investments – and ignores cashflow beyond the arbitrary cut off.

The acknowledged limitation on the NPV approach is that it requires the rate of return to be known. The alternative methodology, often used in conjunction with NPV analysis, is the Internal Rate of Return (IRR) calculation[80]. This method does not have regard to rates of return that might be obtained from alternative investments but has the advantage of being able to be expressed simply as a percentage rate of return on an investment. It relies on the fundamental rationale of the NPV approach: that businesses will invest if the NPV is positive and will be indifferent if the NPV is zero. By setting the NPV at zero it is possible to deduce, by a process of trial and error using educated guesses and mathematical tables, the corresponding rate of return at which the business would make neither a profit or a loss. This can then be compared with the group's required rate of return to determine whether the IRR on the modelled investment is acceptable.

The hurdle rate for an investment in Australia will be influenced by the NPV and IRR analysis. It will also be influenced by the group's WACC. Since this is an after-tax calculation it would be important to consider the likely incidence of tax in Australia, both in

[80] Ibid at pages 274-283.

terms of quantum and the extent to which it may be able to be passed on to customers, offset by price premiums or business efficiencies, or borne by the corporate group (and hence by the shareholders in the form of lower after-tax rates of return on their shares). Opportunities to reduce tax or obtain tax incentives create the potential to obtain even higher rates of return.

Misalignment between liability to Australian tax and economic value created by Australia

To the extent that Australia defines the taxable income of a multinational group as being a lower amount than its economic profits, or allows tax credits and offsets against tax otherwise payable in Australia, there will be a misalignment between the tax paid in Australia and the economic profits earned here. A further misalignment can occur when multinational groups engage in tax avoidance.

As discussed above, it is part of efficient business practice for multinational groups to have regard to tax policy settings and tax impacts in weighing up investment decisions and the structuring of any investment into Australia. Where the Australian operations are part of a global value chain, the multinational group needs to have regard to all of the potential taxing points, including the amount of tax likely to be payable in Australia, and the aggregate tax imposts across all the countries comprising that value chain to determine the group's likely after-tax rate of return.

Arguably, company tax and withholding taxes are seen as costs by multinational businesses. Any benefits multinational groups may obtain from the expenditure of tax revenues in funding the various frameworks needed to sustain an attractive business investment environment are likely to be seen as too indirect relative to the more immediate impact that the payment of taxes does not create assets or generate income for the group. A group may be more conscious of reducing tax costs when the investment carries material and potentially unforeseen risks. Since the group's profit level is a key performance indicator for management remuneration, senior managers seem to have a vested interest in minimising taxes, subject to one potential qualification discussed below. It would be naive for policymakers and tax administrators not to bear these issues in mind when thinking about strategies that will be effective in optimising tax compliance.

The essential focus on the interests of the ultimate shareholders of the parent company will invariably cause the multinational group to assess the commerciality of issues and arrangements on the basis of what is best for the group as a whole. This makes sense from the perspective of achieving the operational and financial synergies that integrated management approach offers. For example, if a multinational group is making profits in one jurisdiction and losses in another jurisdiction, the group, being in a break-even position overall, may therefore seek to avoid the payment of taxes in the profitable jurisdiction. From the perspective of the ultimate shareholders the interests of individual countries like Australia in seeking the proper operation of its tax system are likely to be secondary at best since the tax is likely to be seen by the group as anomalous where it hasn't made an overall profit.

However, where the ***economic*** functions, assets and risks assumed on the Australian side are of economic value, as judged by rates of return obtained in comparable circumstances by independent parties dealing at arm's length in the open market, from a public policy perspective Australia has a legitimate interest in ensuring that the positive economic contribution made is reflected in the calculation of the profits and in tax payments made on the Australian side. It does not necessarily follow within the framework of Australia's

transfer pricing and treaty rules[81] that because a multinational group as a whole is in loss, or that a particular product or service line is producing economic losses, that the Australian operations should share that loss, even though multinationals and their advisers are likely to vigorously contend for such an approach. The corollary to this is that where the global value chain is profitable the rate of return to the Australian side depends on the conditions that would operate in connection with the commercial and financial relations between independent parties dealing wholly independently with each other in comparable circumstances (sections 815-115 and 815-125 of the *Income Tax Assessment Act 1997*). It does not depend on what share the group is able or prepared to pay out of the channel profit to the Australian business.

One partial qualification in relation to a general attitude of tax minimisation is that Australian headquartered publicly listed companies may get share price support from large institutional investors like Australian superannuation funds and charities who can use the 30% imputation credit on dividends they receive to reduce tax on other income or obtain an imputation credit refund. Where this is the case the relevant Australian headquartered multinationals would have an incentive to at least pay sufficient company tax to fully frank all of their dividends. However, even in those cases corporate management would, under standard accountability processes, need to be able to demonstrate that the after tax profit at the corporate level meets the group's expectations in terms of hurdle rates and is sufficient in terms of free cashflow (or in some cases sustained borrowing capacity) to fund the dividend or other capital return payments that shareholders expect. The after tax returns would also have to be sufficient to provide for any reinvestment or debt reduction the group regards as a strategic priority.

Other Australian headquartered publicly listed and privately held companies may seek to optimise returns to shareholders through capital growth rather than dividends, or they may have a significant portion of non-resident shareholders. In these cases, imputation and any offsets that may be available to a group in the form of foreign tax credits are likely to have little if any influence on the group's Australian tax performance.

Given the focus on shareholders' interests within the competitive market system, the tax attributes of the ultimate shareholders in a multinational group are likely to be a significant driver of the multinational's tax performance in Australia. As discussed above, group management are likely to be disposed to tax minimisation since higher after-tax returns to shareholders it generates are likely to be beneficial to their remuneration. Other factors like public reputation may influence tax performance in some cases, perhaps where the group's tax performance is public knowledge and consumers have similarly quality and price alternatives from groups paying their taxes, or where effective relationships and a positive standing with the Commonwealth, the States and the Australian public are critical to business outcomes.

Potential multinational investors and/or their tax advisers will have regard not only to the statutory rate of company tax but to the structure of the whole set of tax law provisions relevant to their intended operations in Australia (and any linked operations in other countries). It would be reasonable to expect that potential investors would have regard to tax

[81] Australia's transfer pricing rules are contained in Division 815 of the *Income Tax Assessment Act 1997* and (generally speaking) Articles 9 (Associated Enterprises) and Articles 5 and 7 (Permanent Establishments) of Australia's Double Tax Agreements. In respect of some prior years of income Division 13 of the *Income Tax Assessment Act 1936* may be relevant.

expenditures, concessions, exemptions, credits and offsets that could reduce the effective rate of tax on their accounting profit below the 30 percent current statutory rate. For example, relative to what would be calculated under accounting rules and arm's length market practice, Australia's capital allowance, research and development and thin capitalisation provisions may provide higher allowances for depreciation, mineral exploration, expenditure able to be classified as research, and interest expense. Using Australia as a base for investment in other countries may provide interest deductions in respect of conduit financing, even though the income from the overseas investments is exempt from Australian tax[82].

The nature of the analyses needed to determine the incidence of taxation requires (possibly with the assistance of law and accounting firms that have global networks) consideration of the parameters of the building blocks of the Australian tax law, whether those building blocks form a coherent framework, and how that framework gels with those adopted by other countries. It is likely in that process that multinationals would examine whether Australia's tax rules themselves provide any tax minimisation opportunities, whether through deficiencies in their structure or any lack of coherence between interrelated parts of Australia's tax law, or through the interaction of Australia's tax law with the tax laws of other countries. It would also be reasonable to expect that multinationals would have regard to whether any global tax planning strategies might be available to reduce tax in Australia and any other countries comprising the global value chain, even if they required contrived structures and transactions not related to pre-tax business efficiency.

The question at the time of making investment decisions is how Australia's tax rules are likely to impact on the share of EPS and ROE that the operations in Australia can deliver to the parent company's shareholders. This question will arise regardless of whether Australian company tax is likely to be borne in an economic sense by consumers, labour or capital. In cases where competitive factors prevent the tax cost being passed on to customers or offset by revenue efficiency and cost efficiency options that can be pursued by the Australian business, the tax impact falls on capital. Where the group can achieve the acceptable post-tax rate of return on an investment in Australia under current tax rules, any avoidance of that tax generates a premium for shareholders. However, in assessing potential future tax risk at the investment stage it would be important to distinguish between the use of legal structures and transactions as elements of tax planning and the question of whether those structures and transactions are likely to pass scrutiny by the ATO and be effective in law, or expose the group to penalties.

Base broadening and base protection allow greater flexibility to adjust company tax rates

The stock of foreign investment in Australia reflects previous investment decisions, taking into account all factors considered to be relevant by those investors, and is subject to current tax rules defining Australia's tax base and rates of tax. If one adopts the working assumption that multinational groups will ***optimise*** their tax payments and effective rate of tax - and the criticality of after-tax rates of return (and perhaps imputation benefits) to shareholders seems to be a strong basis for doing so - a material reduction in the company rate of tax is likely to have a significant immediate revenue cashflow impact. This seems likely given the existing stock of investment and the significant budget contribution from company tax revenue collections, without any allowance for a tax gap. While a reduction in the statutory rate of company tax may have some beneficial impact for some foreign investors, it would be less

[82] See section 25-90 of the *Income Tax Assessment Act 1997.*

relevant to multinationals that get major tax concessions, are already managing their Australian tax position, or have structured their Australian operations as loss making. It is likely to have a significant revenue effect concentrated on Australian based multinationals, especially those paying significant amounts of company tax. This could be tested by using tax return data to compare the relative contributions to company tax from foreign based multinationals, Australian based publicly listed multinationals and Australian based non-listed multinationals[83].

While already alluded to as an issue, what is not taken into account in the analysis thus far is the existing tax gap and the effective tax rate trends in relation to multinational groups operating in Australia. To the extent that there is reasonable certainty as to what the legislation covers, the collection of income tax from multinationals operating in Australia depends to a large extent on the risk appetite of the particular multinational group. It is also based on the ability of the tax administration to effectively identify and address at the individual case level (and through suggested policy reforms) the challenges that pose material risks to the whole system. Perceptions of the relative skills of the private sector, professions and the ATO in deciphering global arrangements and negotiating or litigating outcomes are likely to factor into the risk assessment multinationals and their advisors make in relation to possible tax exposures. In so far as is practicable, allowing for the reality that there will in a range of cases be differences in professionally competent judgments, and sound administrative practices would dictate that settlements have a legitimate role to play, taxation should be imposed according to principle because processes that to any significant degree produce taxation by negotiation encourage an enduring game-playing attitude that is inconsistent with good compliance strategy and the rule of law. It may also create significant and ongoing tax base leakage. Quite apart from that, in an economic sense there should be a financial downside to aggressive tax planning in order to deter multinationals from taking such positions. Penalties are consequential on underpayment of tax resulting from particular behaviours. A less than rigorous approach to the imposition of penalties in the course of settlements undermines the public policy basis for the penalties regime. All these issues are discussed further in Chapter 11.

Base broadening by targeting tax loopholes, overly generous concessions, any under-calibration of profits for tax purposes relative to economic and financial outcomes, combined with strategic investment in tax compliance, offer revenue savings that could fund a company tax rate reduction or targeted concessions that may be needed to best position Australia internationally. Politically it may be more palatable to invest in tax compliance and close loopholes than to rein in tax concessions, but wide support might be able to be generated for tax reforms that broaden the base and reduce rates in order to best position Australia globally. That said, it is nevertheless vital that compliance risk assessments by the ATO cover all material aspects of the Australian operations of multinationals rather than be narrowly focussed on isolated issues. It is also important that they identify and address not only procedural compliance but also tax structuring and systemic weaknesses in the code of law, and that these are promptly acted on at the policy level. A “whole of tax code” and

[83] From a public policy perspective it would be worth examining Australian based non-listed multinationals comparative tax performance given they are not as transparent and accountable as publicly listed Australian based multinationals. The foreign based multinationals have considerable flexibility in tax structuring and reporting their accounting profits since their financial statements and statutory reports are not critical to running their Australian businesses beyond any compliance requirements regarding lodgment, debt/equity requirements and solvency – and imputation benefits are unlikely to be significant. Tax risk assessment is discussed in detail in Chapters 8, 9 and 11.

competitive market system frame of reference, that is informed by a knowledge of global tax planning opportunities, assists this process by allowing all stakeholders to ensure tax laws are delivering a clear and coherent policy intent that is aligned to the competitive market system. It also ensures tax policy settings are appropriately balancing the revenue raising and wider policy objectives being sought. For private sector tax advisers who are familiar with the taxpayer's business, this "whole of code" frame of reference is a natural part of the analyses they have to perform to determine the incidence of Australian tax; but it incidentally allows the identification of strategic tax planning opportunities domestically and globally.

Adopting a process that is based on significant real-life events for multinational groups is more likely to identify any lack of coherence in Australia's tax laws and whether those laws make sense in the real world of corporate financing. For example, while it is important to understand the parameters of each of the building blocks of the Australian company tax provisions (like the debt/equity, thin capitalisation, transfer pricing, tax consolidation and interest withholding tax rules), further important insights are gained by looking at those provisions through the real world of corporate financing to see if the various rules form a properly integrated, practicable, coherent set of rules based on market and commercial realities and that provide an economically realistic calculation of accounting profits and taxable income. Focussing on significant real-life events is also a valuable tax risk assessment tool because it allows an examination of whether the tax performance of a multinational aligns with what is happening in the real world of that taxpayer.

Chapter 5: The competitive market system for debt and equity funding

This Chapter describes the financial market context that needs to be taken into account when considering tax policy settings that impact on corporate financing. It covers the distinctive roles and risks that equity and debt funding have in business financing, the different ways in which shareholders and lenders are rewarded and the different tax treatment accorded to profit distributions on the one hand and interest expense and bad debts on the other. The Chapter discusses the relationship between the group's capital structure and its WACC, which is critical to their profitability and competitive position. It also explains how the competitive market system establishes limits for a multinational group's tolerance for debt funding and its minimum equity funding requirements.

The Chapter discusses the implications these market realities have for the tax treatment of equity and debt and the pricing of debt for transfer pricing purposes.

In the competitive market system debt and equity funding arrangements between arm's length parties are marshalled to develop or acquire assets and fund operations that, through relationships with suppliers and customers, generate flows sufficient to reward the debt and equity funding providers for the different roles they perform and the different levels of risk they assume. In the open market these differences are reflected in the price and other conditions applicable to the debt and equity funding. Since the business investment risk assumed by an equity participant is generally higher than the credit risk assumed by a lender, assuming there are no critical information asymmetries or market abnormalities, the returns on equity sought by investors are generally higher than interest rates sought by lenders. However, in difficult trading conditions it may be that interest rates are higher than returns to equity holders. It is clear though that the competitive market system operates on the basis that reward (or the potential for it) needs to be commensurate with the level of risk being assumed.

A two-sided analysis is needed to understand the role of debt funding in relation to the operations of multinational businesses: how capital markets approach lending to multinationals; and secondly, how multinationals themselves approach the optimisation of funding and cashflow across the group as a whole and in relation to their Australian subsidiaries.

Rating agencies like Standard and Poor's (S&P) have developed extensive materials explaining the development and use of credit ratings to assess the preparedness of a borrower to meet their obligations on time and to assess the risk that a particular debt issue will default. An outline of their framework for rating industrial companies and utilities, 19 November 2013 and republished on 8 February 2017[84] and their General Criteria: Group Rating Methodology, Nov. 19, 2013 and republished Dec. 22, 2016 are set out in Appendix 1.

The S&P ratings methodologies contain extensive explanations of the elements of their entity and group frameworks, and how quantitative and qualitative factors are used in the weighting process to derive credit ratings. These should be taken into account when considering how to apply the ratings methodologies in a particular case.

[84] S&P Global Ratings, Criteria/General: Corporate Methodology, Nov 19, 2013 and republished Feb. 8, 2017.

Credit ratings have significant implications for multinational groups, investors, lenders, suppliers and the credibility and reputation of the rating agencies themselves.

According to the evidence given in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092* lending institutions perform their own independent credit analyses even though a borrower may be rated by one or more rating agencies (at paragraph 169, which was accepted by his Honour Robertson J at paragraph 181). This is unsurprising given that, unlike a rating agency, they are actually assuming the credit risk and will have "a conservative eye to what could threaten repayment of the loan" (paragraph 170). However, it would be extraordinary if there were not significant similarities between the models used by lending institutions and the methodologies used by the rating agencies. The relevant analytical approach would seem to depend on whether a multinational was raising wholesale financing from the money and capital markets, or was borrowing direct from one or more financial institutions. Wholesale finance is typically raised under a prospectus with the issue rated by a rating agency, with the likelihood that a syndicate of banks will underwrite the offer of debt securities to support the funding requirements of the issuer and provide a secondary market so that investors have liquidity.

The *Chevron Case* is also an example of the fact that there will often be specific credit metrics that apply to entities within a particular industry, in that case exploration and production companies in the oil and gas industry (paragraph 177).

Unless a particular lending transaction is part of a wider arrangement that presents other potential economic or financial benefits that are acceptable on a risk/reward basis[85], arm's length debt providers can be expected to follow market practice and can reasonably be expected to only advance requested levels of debt funding to counterparties they regard as creditworthy for that amount. In other words, they determine whether the borrower can repay over the tenor of the loan on the desired payment dates the principal and a quantifiable and limited return that reflects the prevailing cash rate plus an additional component to reflect the risk that the particular borrower may default. In broad terms this can be described as the assumption and pricing of credit risk. The granting of credit facilities and financial guarantees will involve similar considerations.

In deciding whether to lend to a multinational regard is typically had to the value and quality of the borrower's assets, the extent and profitability of its operations, its future prospects, the current extent to which the group is funded by debt and equity, and the strength of the group's present and future cashflows. The market looks to the multinational group as a whole, its financial strength, and the extent to which lenders can call on that strength in relation to any debt funding they provide, particularly since multinational groups may use a treasury subsidiary as the legal entity undertaking the debt raising. It would be reasonable to expect that prospective lenders will seek the widest recourse to group assets in the event of a default by a subsidiary, though security, parent guarantees and in some cases letters of comfort may suffice. Any uncertainties in financial outlook or sufficiency of collateral affect credit risk and are likely to be factored into the pricing of the funding. The prospective

[85] An example of this would be the preparedness of a lender to provide debt funding at concessional rates in return for the right to take an equity stake in a venture seen as particularly attractive. (See the facts and circumstances outlined in *Fairway Estates Pty Ltd v Federal Commissioner of Taxation* (1970) 123 CLR 153; 70 ATC 4061).

lender is likely to have regard to the difference additional debt will make to the borrower's operations and financial profile, examining the likely changes in assets, revenues, costs, cashflow, shareholders' funds, country risk, market position, as well as market conditions in the borrower's industry and the outlook for the local and global economy.

Security, financial covenants, guarantees and other financial assurances

Depending on the circumstances, lenders may also seek priority over other creditors or require security, a performance or financial guarantee or additional assurances, financial covenants and regular reporting obligations in order to make the lending risk acceptable (by reducing it) and allow the lender to effectively manage recovery at the earliest sign of any difficulty. Such arrangements, which can be seen as including debenture issues, may also allow the borrower to negotiate a lower rate of interest on the particular loan subject to any limitations arising from undertakings and covenants the group has entered in respect of previous borrowings.

In the case of security, the lender and the borrower have different interests. The lender is seeking to lower the lending risk by obtaining further recourse in the event of a default in order to avoid incurring a loss. The lender ideally wants to avoid lending to customers who have a significant risk of default. Nevertheless, the chance to obtain higher return on the loan or to build a significant ongoing relationship may induce a secured lending. The security may be structured as general recourse or limited recourse (recovery usually being confined to what is acquired with the borrowed funds). However, the security has to be fit for purpose. For example, the offer to pledge special purpose remote area assets by a mining or energy company may not be attractive to a prospective lender because they may have little or any value in the event that the venture fails. Moreover, security will not induce a commercial lender to advance significant amounts of funding if the borrower is unbankable; that is, its creditworthiness is so weak and its business risks so high that a lender would see the prospective borrower as an unacceptable lending risk. For example, a resources company that is in the exploration or build phase of its operations may find it difficult to attract any funding other than equity, assuming the market regards the business as having sufficient prospects to subscribe for equity interests.

The borrower, assuming it is creditworthy, is seeking to obtain the required funding at the lowest cost and may be prepared to give security, financial covenants or other assurances to achieve those ends. However, a multinational group may be unwilling to give security so as not to restrict its flexibility over the management, ownership and disposition of assets. It may also see certain financial covenants as being unduly restrictive, or costly, or prohibited by covenants provided in respect of earlier borrowings. Letters of comfort may be proposed in lieu of formal restrictive arrangements but their acceptability to a borrower, or the directors of the local subsidiary, will depend on the relationships between the parties and whether the letter of comfort is legally enforceable. The outcome of the proposed incremental borrowing arrangement will in part depend on the respective skills and bargaining position of the parties to the negotiations and whether the lender is seeking the status of a relationship lender to the multinational group. However, from a strategic perspective, if a multinational wants to retain the greatest flexibility over its operations it needs to have a strong balance sheet and good cashflows. In the final analysis new ventures may be restricted to equity funding if the investment risk exceeds what a lender would normally accept.

In some circumstances the competitive market system for debt funding enables a borrower with a lower but sound credit rating, say BBB^- or above ("investment grade") and desiring to undertake a substantial borrowing to enhance its credit rating by obtaining a guarantee from a higher rated entity, for example a company that has a AA or AAA rating. The monoline insurance market is an example of highly rated entities seeking to derive guarantee fees from the use of their credit rating by lower rated corporations issuing bonds. This is sometimes referred to as credit wrapping. However, the opportunity to access such arrangements is very limited because prudential regulations or group policies are likely to prohibit instrumentalities and multinationals from assuming financial risk exposure in such arrangements. The lower rated entity would need to have a sufficiently strong credit standing to be able to borrow the funds in its own right and would be required to pay a guarantee fee for the credit rating enhancement. Theoretically, the fee would be calculated by reference to a probability of default calculation and have regard to the amount of the borrowing being guaranteed and any recoveries that the guarantor could make through its right of subrogation. In other words, the pricing process used by loan guarantors bears close similarities to that used by lenders in setting interest rates; in both cases regard is had to the probability of default, the exposure in the event of a default and the ultimate loss given default after any recoveries. However, against the backdrop of the pricing in the credit default swap market for loan insurance, independent parties may seek to negotiate some sharing of the financial benefit the borrower derives from being able to borrow at a lower rate of interest, especially if its stand-alone creditworthiness suggests that the likelihood of a default is remote. The giving of a guarantee to a borrower that is creditworthy will require the guarantor to setting aside some capital on a risk-weighted basis to cover the risk. Accordingly, both parties have a vested interest in the guarantor having the necessary financial strength.

Guarantees from highly rated companies can provide lower rated investment grade companies with access to wider sources of funding, for which they may be prepared to pay a guarantee fee. For example, the raising of debt funding through widely distributed commercial paper in the wholesale finance markets generally requires an A grade credit rating and a parental guarantee. Corporate policies may also restrict lending by multinationals of cash surplus to current requirements to borrowers that have credit ratings of A or above.

Where a borrower company is judged as not being sufficiently creditworthy for the debt it is seeking it will be unable to obtain a financial guarantee from an independent party in relation to that borrowing because the risk of default would be too great. An independent guarantor would not countenance the giving of a guarantee to an entity that is not creditworthy in order to make it creditworthy. This would be tantamount to the guarantor covering the capital and cashflow inadequacy of the borrower and would expose the guarantor to the investment risk associated with the borrower's business. In such a case the pricing of the guarantee becomes irrelevant. The provision of parental guarantees to group subsidiaries is discussed in Chapter 6.

Similarly, where a multinational group seeking debt funding from independent parties is not creditworthy for a loan of a particular amount, the pricing of that debt funding becomes irrelevant; it would be an unnecessary and artificial exercise to price a loan that will not occur between independent parties dealing at arm's length with each other. While structured transfer pricing strategies involving thinly capitalised structures may be attempted, it seems implausible to suggest that in such a case a very high interest rate reflecting the non-bankable status of the borrower entity on a stand-alone basis is appropriate for a related party loan in a

case where the loan would not have occurred between independent parties dealing at arm's length with each other. Evidence of comparable independent transactions is needed before a related party dealing could be judged to be arm's length.

Capital markets may provide an alternative (wholesale) source of cheaper debt funding for multinational groups that have a strong credit rating and are prepared to provide a parental guarantee. They may also provide a marshalling point where the amount of the debt exceeds the single client credit tolerance of financial institutions or where there is insufficient depth in local money and capital markets. The guarantee facilitates the marketing of the securities because debt investors know that in the event of a default they can go direct to the parent for immediate repayment without delay or argument. A multinational group seeking to avail itself of this funding source is likely to use a finance subsidiary with a parental guarantee to issue the commercial paper and a syndicate of banks to underwrite the issue and provide liquidity in case debt investors wish to sell their securities at some point before maturity. In contrast to the case of party to party lending the interest payments made by an Australian subsidiary to non-residents on widely distributed debt securities are likely to be subject to a specific interest withholding tax exemption[86].

Credit facilities, lines of credit and commitment fees

When a lending institution or panel of lenders agree to provide a committed level of debt funding to an independent borrower as and when the borrower may decide to draw down on that facility they have to make provisions for the equity cover that they will attribute to the facility based on the risk weighting of the arrangement as and when drawdowns are made.

These facilities may be put in place to cover planned expenditures where the dates of those expenditures are likely to occur in the near term but are somewhat uncertain. For example, where the borrower is seeking to acquire another company and expected to do so in tranches. Or, where it may from time to time need access to an overdraft facility to cover short term operational requirements.

The lender(s) will also have to make provisions to ensure that the nominated cash limit will be available at the time the borrower calls for it. This will mean that the lender(s) may have to place the funds in investments where they can be recalled when the borrower notifies it wished to make a drawdown. Such investments may not provide the lender(s) with as high a return as other options might. Accordingly, the lender(s) will charge the borrower a commitment fee to have funds up to the nominated cash limit on standby.

Factors affecting the group's mix of debt and equity funding

Arm's length providers of equity assume a business investment risk. They rank behind creditors in the event of a winding up. For that reason the extent of equity funding a group has access to, whether by way of subscribed equity, convertible debt or retained earnings, is a key factor for prospective and existing lenders and suppliers, though financial reporting and access to the necessary financial information on a timely basis may present an issue. Equity participants are not assured of a return of their equity funding or any margin on that funding, and profit distributions are at the discretion of the board of directors. Conversely, unlike debt

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[86] See section 128F of the *Income Tax Assessment Act 1936* and the discussion of withholding taxes in Chapter 2.

providers, equity providers are generally entitled to a relevant share of any economic upside. Apart from special categories of securities like redeemable preference shares which carry a specified rate of return, which may be cumulative or non-cumulative and may be in priority to returns on other classes of shares, the returns to equity providers are not limited like interest rates on debt funding.

A group's equity is its buffer against the possibility of losses, allowing the group to underwrite that possibility. Corporate regulation requires companies to remain solvent and for directors and auditors to attest to that solvency and equity can be seen as providing assurance to creditors. As will be seen in Chapter 6 multinational groups have various ways of assuring the solvency of their subsidiaries while allowing them to remain in a structural loss position. For the purposes of this discussion an entity is regarded as being in a structural loss position if its gross profit is negative or is insufficient to cover its fixed and variable operating costs and, on the basis of the current drivers of its income and expenses, it has no reasonable prospects of becoming profitable. However, arm's length parties recognise that sustained periods of losses will threaten the financial viability of the group. In the competitive market system one generally does not observe groups that have negative equity or that are in a structural loss position unless there are significant expected returns that would allow the group to restructure its finances. Without such circumstances the creditors can reasonably be expected to force the winding up of the group in order to minimise their losses and regulators would seek the same outcome in order to protect creditors who may deal with the insolvent group. The position of subsidiaries can be quite different, as discussed in Chapter 6.

Multinational groups will seek to choose the capital structure that minimises the group's WACC, since at this point the value of the group is maximised. In good trading conditions and where interest rates are favourable a group may seek to increase its debt funding and reduce its equity funding by share buy-backs in order to maximise its EPS and ROE. It may also increase its leverage by borrowing the funds needed for new investment (for example, establishing a new business in Australia or financing the takeover of an Australian business). In worsening trading conditions and periods in which economic losses are incurred the increased interest costs from higher debt funding levels will adversely affect EPS and ROE, so management could be expected to seek to pay down debt, ideally as soon as they forecast a worsening profit outlook[87].

Accordingly, the competitive market system establishes limits for a multinational group's tolerance for debt funding and consequently establishes its minimum equity funding requirements. Nevertheless, there is a range of debt/equity configurations that the multinational parent company can adopt and the relevant balance point will be the one that the directors judge will optimise the group's weighted average cost of capital, since this maximises the values of the group and of its cashflows and produces the best outcomes for the parent company's shareholders[88] in terms of EPS and ROE.

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[87] Ross Westerfield Jordan, Fundamentals of Corporate Finance (7th Edition, Alternate Edition), McGraw-Hill Irwin at pages 536-561.
[88] Ibid at page 538, Capital Structure and the Cost of Capital.

The priority given to debt over equity in a winding up may be a reason[89], in addition to the tax deductibility of interest and bad debts[90] and the concessions provided in Australia's thin capitalisation rules[91], why multinational groups might be tempted to use group finance companies established in Australia but in a separate tax consolidated group to finance operating subsidiaries with debt wherever possible. This may especially be the case where the subsidiary is undertaking very high-risk projects because the finance company may be able to claim bad debt deductions on revenue account and the operating subsidiary may be able to claim capital or revenue deductions in respect of its losses.[92] The ultimate recoveries for the parent company in respect of a defaulting subsidiary may be significantly enhanced relative to the proportional share of residual assets for other creditors through the accrual of interest costs during the period of the lending and in the proof of debts in a winding up, especially if higher interest rates become applicable in the event of a default. This compares to the provision of "cost free" equity funding which is subordinated to the claims of creditors. This of course assumes that any arrangement of this kind does not give rise to an undue preference. The interest expense incurred by the Australian subsidiary is generally tax deductible at the 30% company tax rate, subject to the operation of Australia's thin capitalisation, transfer pricing and general anti-avoidance provisions. Where the debt funding has been borrowed from an offshore affiliate or the group's bankers interest withholding tax of 10% is payable to the extent interest payments are actually made[93], though section 128F provides for an exemption if the funds are raised through publicly offered debentures and debt interests even where the funds are raised by a subsidiary finance company whose only business is raising funds for its parent.

Any direct rewards to the equity holder will arise in the payment of dividends, bonus share issues, capital returns, share buy-backs or the increase in value of the equity interests through the retention and reinvestment of profits. Shareholders in listed companies can also derive gains from market valuations if their shares are in high demand. However, they can also incur losses.

EPS and ROE are generally regarded as key measures of a group's financial performance. However, there is a clear interrelationship between these measures and the extent and cost of the group's debt funding. Where a group is listed on a stock exchange the price of the shares can be affected by a range of circumstances beyond the particular financial profile and performance of the group itself. There can be marked differences between the market capitalisation of a group and the amount of equity a group carries in its balance sheet. Market to Book and Price-Earnings Ratios may be used, supported by appropriate elements

[89] See for example *FC of T v Ashwick (QLd) No 127 Pty Ltd & Ors* [2011] FCAFC 49; 2011 ATC 20-255 at paragraphs 93 points (1) and (3), 115 and 121 of the judgment of Edmonds J but note his Honour's statement at paragraph 121 point (4) that there was no finding of fact on these aspects by the primary judge, Ryan J, who simply observed: "I do no consider the fact that income producing activities undertaken in the course of a business may have other purposes or effects militates against the entitlement of a taxpayer conducting those activities to deduct from the assessable income thereby produced an expense of a revenue nature incurred in deriving that income". ([2009] FCA 1388; 2009 ATC 20-146 at paragraph 200).

[90] Sections 8-1 and 25-35 of the *Income Tax Assessment Act 1997*.

[91] Division 820 of the *Income Tax Assessment Act 1997*.

[92] See for example *FC of T v BHP Billiton Finance Ltd* [2010] FCAFC 25; 2010 ATC 20-169.

[93] Subsection 128B(2) requires that interest must be derived by and paid to a non-resident for withholding tax to apply.

of judgment, as market value measures of group performance. Where market capitalisation is strong it may assist a group in raising debt funding.

The balance of debt and equity funding is a critical issue for corporate groups. Since the different roles and risk profiles of these funding types mean that debt is generally cheaper than equity on a pre-tax basis there is an incentive for groups to optimise their debt funding. The higher the debt tolerance of a group the more beneficial that can be for returns on equity, assuming the group is using its funds productively.

The extent to which the group is leveraged is also important to the debt and equity markets and financial institutions because, once the group's debt funding reaches a material level, the risk of default increases the higher the proportion of debt in the group's balance sheet, though overall asset size may still provide a sufficient buffer for lenders. For this reason, debt markets and financial institutions may include specific financial covenants to limit the group's leverage to a specified debt to equity ratio and limit the group's ability to provide securities or priority to other parties and may insist on regular financial reporting to guard against information asymmetries, insider information that may put an external lender at a disadvantage. Lenders will have regard to the ability of groups to deal with the assets and income of their wholly owned subsidiaries and are likely to arrange their loans in a way that gives them the greatest protection in the event of any default or financial stress in any part of the group. (See also the discussion of the funding of group subsidiaries in Chapter 6.)

Equity markets may punish a particular stock if the proportion of equity funding is judged as being too high. Generally speaking, the unused scope for additional debt funding may suggest the group has a "lazy" balance sheet and management are forgoing growth opportunities. However, equity markets may tolerate, or even reward a group which is seen as temporarily having a lazy balance sheet if the market has a basis for believing that the group is building a "war chest" to support acquisitions, or the broader economic or market conditions dictate prudence and a preference for safe haven stocks.

A group's credit rating is another critical factor in determining funding strategies. It may impact on a group's ability to raise its desired level of debt or equity funding, the price it has to pay for debt and the price it can obtain for equity issues. The wholesale finance markets are generally limited to borrowers with strong credit standing to give those markets confidence that the acquirers of debt securities will be paid on time and will be able to sell their securities before maturity should they need that liquidity. In the case of group subsidiaries these markets are accessible only with the benefit of a parental guarantee (as seen in the *Chevron* Case discussed in Chapter 6). While in some cases wholesale funding may be available for sub-investment grade entities (through what is often referred to as the junk bond market) the amounts available may be limited, the security requirements and financial covenants stringent and the funding very expensive. Group financial and business management strategies are therefore directed to achieving and maintaining a credit rating that gives the group the financial flexibility it needs and optimise its WACC (which is based on its weighted average cost of equity and its weighted average cost of debt). This has implications for how group treasuries need to operate. Group policy and treasury controls seek to prevent the fragmentation of the group's financial strength by a centralised approval process for external borrowings and financial risk management so that only net borrowing requirements and net exposures are accommodated unless an exception is justified as providing a benefit to the group (for example a loss in one jurisdiction can be offset against a profit in another, or there may be tax benefits). They also create the framework for

budgeting, cashflow management, including the placement of any surplus cash, and for assuring the liquidity and solvency of group subsidiaries by arranging debt or equity funding or other assurances (for example, extended terms of trade, financial guarantees, letters of comfort, or the capitalisation or rescheduling of debts owed between group entities). Any transactions, structures and processes that deviate from the treasury controls should be subject to scrutiny.

Rating agencies tend to look at corporate groups as a whole and do not generally rate subsidiaries unless a special need arises. Their rating processes are directed to establishing a longer-term assessment of creditworthiness, though they have processes for placing groups on credit watch. While there is a range of quantitative and qualitative factors adopted by rating agencies, in the rating process significant weighting is placed on the amount and quality of the group's assets and on the drivers and expectations of the group's cashflow, liquidity, productivity and profitability. (Standard & Poor's ratings frameworks are included in Appendix 1.) In the generality of cases groups present their strongest financial profile at the consolidated level, particularly where they have full control of their subsidiaries and can thereby determine the subsidiaries' strategies and can access their assets and cashflows.

Groups will seek to put the best light on their creditworthiness when dealing with financial institutions, which tend to perform their own credit risk assessments of prospective borrowers, though asset size, asset quality and drivers and expectations of cashflow, productivity and profitability remain key. Critical to banks assessments will be the ability of a prospective borrower to service the debt, which can be gauged through financial ratios like the debt service coverage ratio[94], the times interest coverage ratio[95] and the cash coverage ratio[96]. In addition there are industry specific ratios.

Net interest margin, bad and doubtful debts and return on equity are key measures of a bank's performance. Banks will also have prudential limits in relation to their exposure to a particular multinational group and, given their measures of success, can be expected to take a fairly conservative approach to pricing financial risk and protecting themselves from bad debts. However, financial institutions will have their individual strategies regarding market share and profitability and may make special relationships with and offer pricing benefits to multinational groups for whom they wish to be a relationship banker.

In arm's length dealings credit risk assessment involves the formation of a judgment about the likelihood that a group borrower will default in relation to the timely payment of principal and interest, the financial exposure the lender will have should that occur, and the loss that is likely to arise for the lender in such a default after all potential recoveries and competing claims have been taken into account. Debt markets, financial institutions and other arm's length lenders would not reasonably be expected to lend on an unsecured basis if the risk of default is significant, potentially giving rise to the need for parental guarantees, security, priority or other financial comfort to be provided by the group in order to obtain the funding

[94] The debt service coverage ratio measures the annual cashflow available to pay the debt obligations that arise during a particular year or series of years. It includes the obligations to pay interest and principal. The available debt service funding is calculated before depreciation and amortisation since these are non-cash items and interest expense and repayments of principal are then deducted.

[95] The times interest coverage ratio is calculated by dividing EBIT by the interest payable during the year.

[96] The cash coverage ratio is calculated by adding depreciation and amortisation back to EBIT and dividing the resulting total by the interest expense for the year.

it seeks and get that funding at the lowest practicable cost. In the event that such a guarantee, security or other financial accommodation was not available it would be reasonable to expect that the group would not be able to borrow, or would be limited to a lesser amount at a cost reflecting the group's credit standing. (See also the discussion of security earlier in this Chapter.)

Where one group in an industry has a better credit rating and a lower cost of debt than a comparably sized or smaller competitor, leaving aside any regulatory constraints on a takeover, the group with the lower cost of debt may be in a position to acquire its competitor and run it more profitably simply because the acquiring group has a lower cost of funding, quite apart from any business efficiencies that may arise from merging the two sets of operations. The relative cost of funding is therefore a potential dynamic in market competition and in building market share. The group's taxation strategies play an important indirect role in this regard because underpayments of tax that are unable to be promptly recouped by the relevant tax administration increase profits and strengthen the group's financial profile.

From the perspective of the borrower group the cost of its debt funding is regarded as an expense associated with its production or investment. The returns to its equity participants are distributions of group profits after full accounting for operating expenses and depreciation/amortisation that the group does not need for reinvestment.

Having regard to the different roles and risk profiles of debt and equity funding in the competitive market system - and how they are used and rewarded by multinational groups - it is neither practicable or desirable to equate them. To do so would either shield company profits from taxation or would disallow tax deductibility for interest expense. In both cases it may increase the cost of capital. However, from a corporate group perspective there are advantages if the funding can be regarded as equity for capital adequacy regulatory purposes and debt for tax purposes (since the deductibility of interest expense reduces the after-tax cost of the funding), though the operation of thin capitalisation regimes would have to be considered. To the extent that thin capitalisation regimes allow debt levels above what could be achieved in the competitive market system the excess debt is in effect substituting for additional equity that the market would require. The earnings on that excess debt would otherwise be treated as taxable business profits. Moreover, the tax deductibility of the interest expense associated with the excess debt shields other business income from tax.

Implications of geographical spread for business risk and exchange rate exposure

Multinational groups are likely to have operations in several countries. This geographical spread provides a level of protection against the risk of an economic downturn in a particular economy. However, the business risk will be impacted by any economic and market characteristics that are particular to a country in which a multinational group carries on business. Their assets, incomes, expenditures and profits may be exposed to exchange rate risk depending on their location. Multinational groups will have a functional currency in which they express the investment, profitability and financial profile of the group as a whole. The extent of the exchange rate risk will be affected by the residency of the parent company shareholders, the currencies in which assets are held, goods or services are sold, material items of expenditure are incurred, and the currencies in which external borrowings are raised.

Exchange rate risk will also be impacted by a multinational group's policy in relation to hedging. As hedging reduces profitability as well as limiting losses, and recognising that they may have natural hedges available to them, multinational groups may adopt a policy of not hedging, giving investors full exposure to market risk and potential upside. Some may partially hedge their net real world exposures. Groups may also seek to match income, expenditure and assets in a common currency. It is therefore important to understand a group's hedging policy and to identify any instances where there is a deviation from that policy. For example, a group may direct subsidiaries to formalise a natural hedge between Australia and another country to incur a loss to neutralise or reduce a taxable position in Australia and allocate the corresponding profit to another country that does not tax the gain or has sufficient losses to offset the profit.

Economic theory suggests a correlation between the relative strength of a currency and the prevailing interest rates in that country and, particularly in an economy like Australia, the prevailing commodity prices. The Australian dollar is freely traded but there are challenges in achieving exchange rate settings that would optimise Australia's global competitiveness despite a below trend growth rate, a significant fall in commodity prices in recent years and a series of cuts in official interest rates bringing them to historical lows. Paradoxically to our relative economic size as a share of global GDP our currency is one of the most traded. The scale of cross currency speculation, margin driven algorithmic trading, quantitative easing by some major economies, and the relative strength of the Australian economy despite its below trend performance, make the effectiveness of monetary policy setting by the Reserve Bank problematical, putting a heightened focus onto fiscal policy settings.

Cash rates and credit spreads can vary significantly from country to country. For example, historical comparisons may show that cash rates are higher and credit spreads are lower in Australia than they are in the US. The debt market structure may also vary from country to country, for example the availability of wholesale funding and sub-investment grade (junk bond) financing. Pre-conditions for accessing these markets would also have to be considered. For example, wholesale funding may be available only to highly credit rated entities with parental guarantees and junk bond funding may not be widely available and may carry stringent security and financial covenant obligations. It would therefore be inappropriate, for example, to develop an interest rate for an Australian dollar borrowing by an Australian company based on US cash rates and credit spreads. Nor would it be appropriate to automatically assume that wholesale funding or junk bond financing would be available.

By contrast intra-group funding arrangements (discussed further in Chapter 6) are not bound by the disciplines and norms of the external debt markets. Since the subsidiaries are under common control, multinationals may adopt processes for providing intra-group funding that do not reflect the credit assessment, interest rate setting, and debt management practices and the whole of group focus typically used by independent parties dealing at arm's length with each other in the debt markets. Intra-group debt funding can be provided in circumstances where arm's length parties would refuse to lend, and the amounts of intra-group funding can exceed the total amount of debt funding in the group's consolidated balance sheet. These unique arrangements raise very difficult transfer pricing and thin capitalisation issues that can only be solved by adopting the capital structure of the consolidated group as a reference point and having regard to how the competitive market system deals with debt funding for multinational groups and their subsidiaries.

Chapter 6: Planning, budgeting, treasury processes and the funding of subsidiaries

This Chapter complements Chapter 5 (which explores the operation of the competitive market system for debt and equity funding) by examining how multinational groups develop their internal funding strategies to provide budget funding, capital expenditure and liquidity to various parts of the group. It also covers the role of the group treasury in pooling surplus funding and managing financial risks on a group wide basis. The Chapter examines the implications centralised financial management and control has for tax compliance in Australia. The Chapter also explores the options that parent companies have in relation to the funding of their Australian subsidiaries and the potential impacts they can have on the payment of tax in Australia if transfer pricing rules are not applied. The objective is to understand how the systemic analysis framework enables the legal structures and the applicable tax rules to be tested by reference to the economic, market and business realities and imperatives faced by a particular multinational group.

The following functions would need to be centrally planned and managed to minimise the group's cost of funds and optimise its overall business and financial performance, including its tax exposures:

- The formulation, execution and evaluation of business strategy and operations;
- The group's business model and the group's corporate structure, including its geographical spread, strategic acquisitions and divestments;
- Global product and service range and pricing;
- Innovation programs;
- Business process design, quality assurance, guarantees and warranties;
- Market strategy, customer loyalty and the management of brands and reputation issues;
- Corporate governance;
- Consolidated financial statements, public reporting and announcements;
- Stakeholder relations with the debt and investment markets and its bankers;
- Relationships with the credit rating agencies;
- Cashflow and financial risk management[97], the planning and management of capital expenditure and operational budget funding; and
- The development and implementation of global tax planning.

At one level it can be readily seen that the funding requirements of a subsidiary or branch within a multinational group depends on the financial risks associated with the role the subsidiary is performing, the need for it to be able to sustainably fund its assets and operations and the extent to which it can generate sales revenue. Depending on the group's business and market strategy, the subsidiary or branch may need investment funding from time to time, or may realise assets not seen as strategic.

Multinational groups have a vital interest in ensuring that the necessary planning, budgeting and cashflow management processes are efficient, properly integrated and controlled. All

[97]The management of financial risks would include establishing and ensuring the ongoing effective implementation of policies and controls to safeguard against moral hazard, managing risks of fluctuating exchange rates and interest rates within the parameters of the hedging policies established by the multinational group, and oversighting the solvency of individual subsidiaries and the group as a whole, taking remedial action as necessary.

parts of the group have to be efficient users of funding and justify their funding requirements. Group delegations and procedures governing planning, budgeting and treasury operations support this intent and ensure funding decisions and expenditures align with the group's strategies and business plans and that there are safeguards against inefficient or unauthorised expenditures and fraud. All funding surplus to requirements is likely to be "swept" into a central group account. Borrowing requirements can then be ascertained on the basis of the group's net requirements and liquidity can be managed with an appropriate mix of overdrafts, short and longer term funding, intra-group loans and other types of credit support or equity contributions. This also allows the net exchange rate and interest rate exposures to be identified so the group can consider whether and to what extent it should hedge. The group treasury would also have to address unexpected liquidity issues that might arise from time to time with subsidiaries so their directors and auditors can make required attestations that the company remains solvent.

Where the borrower company is a subsidiary that conducts operations that are part of the multinational's global economic value chain[98], the establishment of its capital structure and the maintenance of its financial profile are at the discretion of the parent company, apart from regulatory requirements. The regulatory requirements generally relate to the ongoing solvency of the subsidiary and rules relating to capital adequacy and thin capitalisation limits. In some countries there may also be restrictions on capital movements. Special registration systems and prudential rules may apply in the context of banking, finance and insurance businesses.

Business structures and tax structures

It is clearly in the interests of multinational groups for their subsidiaries and branches to maximise their economic contributions to group profit. To that extent the corporate structures and business processes adopted by a multinational group will be lean in order to maximise cost efficiency. Corporate financing would not be an issue to tax administrators if subsidiaries and branches conducted and reported their operations as independent economic profit centres. However, such an approach may inhibit group-wide collaboration to optimise profits for the group as a whole (for example, synergies, economies of scale, the protection of valuable intangibles, the use of offsetting arrangements for profits, losses and financial risks in different countries). It would also preclude the channelling of cashflows, and the use of intra-group dealings to shift value or profits in order to minimise the group's overall tax liabilities. It would also preclude the multinational group from using its overall financial profile to ensure its operations can obtain the necessary funding at the lowest price, for example through parental guarantees.

Multinational groups may establish other special purpose subsidiaries that are not necessary for the performance of its value creating activities. These include entities that help the group to manage the holding and protection of its assets, facilitate the raising of debt funding, create channels for the downstream and upstream flows of funds within the group or are needed as legal structures facilitating the group's tax strategies. The capital structures and financial

[98]The global economic value chain for a multinational group encompasses the economic functions performed, the assets used and the risks assumed that create economic value for the group. It relies on funding from equity participants, external lenders and cashflow generated by its customer base. In some cases the value chain will be dependent on supplies of goods or services by unrelated providers. A multinational group may have several global value chains covering different industry sectors or different goods and services.

profiles of these additional subsidiaries will be influenced by the roles they play. Since they are unlikely to be conducting significant economic activities their funding requirements are likely to be limited to the costs associated with establishing and maintaining them, including meeting any reporting or other regulatory requirements.

Multinational groups therefore need two sets of structures, processes, records, business reporting and performance measures for subsidiary operations; one lens to support accountability and economic performance and the other to allow variations to standard structures and processes that may understate the economic outcomes achieved by an Australian subsidiary but generate net financial benefits for the group as a whole, for example through reducing the tax paid in Australia. Variations to standard structures and processes are therefore a potential signpost to tax avoidance.

The natural corollary to this necessity for different types of recording and reporting is that adequacy and reliability of financial data relating to a subsidiary or branch of a multinational group depends on the purpose and uses of the reporting. This issue is also discussed in Chapter 8. Reports and data used to actually run the business of the subsidiary and evaluate its economic performance have the highest reliability. Important insights into what is economically driven and what is tax driven can be drawn from contrasting the different structures, processes, records, business reporting and performance measures and how they are used by the group (probably best judged by the business or financial goals they relate to and the impacts they have).

Parental guarantees

One way of ensuring the solvency of a subsidiary and allowing it to obtain debt funding at the same cost as the parent would be through the provision of a parental guarantee. The guarantee could be financial guarantee to directly support a loan or a performance guarantee, for example that debt finance related to a plant under construction will be repaid if the plant fails to achieve a certain level of output within a specified time.

It is important to distinguish the role that a parental guarantee has in relation to the capital structure of the subsidiary being guaranteed. A subsidiary could be regarded as creditworthy on a stand-alone basis or because the financial markets take into account that it is affiliated with a financially strong group that is likely to support it in the event of a default. The second scenario is likely to be much more common, given the tax advantages of establishing the subsidiary with a thinly capitalised structure. Were a subsidiary seeking to borrow an amount for which it was creditworthy a guarantee from a financially stronger parent enhances the credit standing of the subsidiary to that of the parent. Given the commercial imperative for multinational groups to minimise their cost of debt funding and to use the full financial strength of the group to achieve that outcome, it will invariably be the case that multinational groups will guarantee any external borrowings by a subsidiary, unless a lender is prepared, absent such a guarantee, but perhaps with a binding letter of comfort, to regard the subsidiary as a core subsidiary and price its debt on the same basis as would be obtained by the parent. The commercial reality is that a subsidiary will never be in a position where it will be allowed to raise significant amounts of external debt funding at a price in excess of that able to be obtained by the ultimate parent company. Moreover, it seems unlikely that an independent party would provide a guarantee to a subsidiary of another group; something that would naturally fall within the role and responsibility of the parent. An independent party is likely to be risk averse in those circumstances because the subsidiary is likely to be viewed as

bearing risks that its parent, which had the best understanding of the subsidiary's operations and financial position, was not prepared to assume. (See also the discussions of group financing and guarantees in Chapter 5.)

An argument can be made out that a parental guarantee is likely to allow a subsidiary to borrow at a lower cost of funds, regardless of how financially sound and profitable the subsidiary is. This is due to the fact that a lender has access to a larger pool of assets and cashflow in the event of a default on the part of the subsidiary, so the risk of a loss to the lender is reduced, even in the case where a subsidiary is financially very strong. The extent of the advantage of a parental guarantee is reflected in the extent to which it reduces the subsidiary's borrowing cost. However, as part of its global taxation strategy parent may seek to manipulate a subsidiary's capital structure and profitability in order to support the charging of a high guarantee fee, much as it might attempt to do this in order to support a high interest rate charge on cross-border related party loans. The market is aware of such practices and will approach the determination of the credit risk associated with lending to a subsidiary on the basis that it is affiliated with a bigger group and assess the likelihood that the parent will stand behind the subsidiary in the event of a default on a loan. The important point here is that these profit shifting strategies depend on the acceptance of the view that the subsidiary should be regarded as a stand-alone entity for tax purposes contrary to market practice. In other words, the success of the tax avoidance schemes depends on the tax rules being read as requiring a subsidiary to be viewed as a stand-alone entity for the pricing of cross-border related party loans and guarantees. This is discussed in detail in the latter part of this Chapter in relation to the *Chevron Case*. But even where the subsidiary is established with the capital structure that allows it to operate as an economically and financially independent profit centre, and intra-group dealings are conducted on an arm's length basis, a parental guarantee is likely to provide an advantage in reducing borrowing costs, subject to what might be regarded as a rare exception. The exception relates to situations where the market and particular lenders providing major party to party finance regard a subsidiary as core to the group's operations and therefore accord it the same credit standing as its parent. (See Appendix 1 which explains the concept of core subsidiaries.)

Where a subsidiary is seeking to borrow an amount for which it is not creditworthy on a stand-alone or an affiliated basis, the parental guarantee in effect compensates for the inadequacy in the subsidiary's equity funding, retained earnings or for its inability on current and expected earnings and cashflow to service and repay the level of borrowings being sought. The market would insist on a parental guarantee. In such a case the parental guarantee is not simply about obtaining a lower cost of funds, it is a prerequisite to obtaining the debt funding. There is no commercially rational basis on which to price the loan or the guarantee because independent parties dealing at arm's length would not provide the loan without a parental guarantee and would not provide a financial guarantee to an entity that was not creditworthy. The necessary parental guarantee is compensating for a weakness in the subsidiary's capital structure and financial profile, that has been established and is being managed by the parent. In open market dealings, where a company needs to carry more equity if it is to be regarded as creditworthy, its financial strength and commercial prospects will determine whether it can raise that equity. In any event, while a company may incur some expenditure in organising an equity raising, it would not have to pay for the equity as such. In that sense the funds are cost free. However, the subscribers would be entitled to the returns and other rights attaching to their class of shareholding, subject to the business investment risk they are assuming.

In relation to the funding of capital expenditure proposals from subsidiaries and any that the parent company board has initiated as strategic options, the multinational group will have to consider the relative merits of those proposals. This process includes having regard to the hurdle rate of return the group is seeking, any regulatory requirements relating to the subsidiaries, the group's free cash flow, the additional cashflow expected from the investments, the group's borrowing capacity and whether the proposed investments make a strategic fit for the group as a whole. Decisions about raising additional external equity and/or debt funding would be made having regard to the matters discussed in Chapter 5.

Financial strategy and tax issues related to the funding of group subsidiaries

Once a decision is made to fund an operating subsidiary, questions will arise as to the source and composition of that funding, whether the group has free cashflow available, whether it should be raised at the subsidiary or group level, how to get any external funding required at the lowest cost, the structure and procedures for getting that funding to the subsidiary that requested it, and the most tax efficient way of providing that funding. The multinational has enormous discretion as to the mix of debt and equity in a subsidiary's capital structure, establishing its functional currency and the financial profile it wishes to create for its subsidiaries and tax impacts will be an important (but not the only) consideration. Part of the reason for this is the fact that the market constraints that drive a multinational group to optimise its capital structure in order to maximise the return on its equity capital and its earnings per share do not operate at the subsidiary level. The subsidiary's balance sheet, profit and loss statement and cashflow, while relevant, are not determinative of the group's creditworthiness. Another part of the reason for this flexibility is the wide range of options parent companies have to ensure solvency and low-cost borrowing capacity without the need to create strong capital structures in their subsidiaries. As the internal effects of intra-group financing will wash out on consolidation of the group's financial results it is important to distinguish between external and internal funding arrangements, including where externally sourced debt funding is channelled through group offshore finance entities to group operating entities in Australia. A subsidiary can carry a much higher proportion of debt funding than a parent company. Australia's thin capitalisation rules allow an entity in the industrials sector to have $6 of debt for every $4 of equity, based on the valuation of its Australian assets. By contrast, in order to minimise its cost of capital, the ultimate parent company may have to limit its borrowings to $4 of debt for every $6 of equity. Because it can rely on the financial strength of the group as a whole a subsidiary can carry much more debt in its balance sheet than it would ever be able to borrow as a stand-alone entity. This interdependence is recognised by all parties within the competitive market system. Multinational groups do not generally establish the capital structures and financial risk profiles of subsidiaries on the basis that they are separate profit centres capable of borrowing on a stand-alone basis at the lowest cost. In fact, even if they were, it is doubtful they would be able to borrow as cheaply as the group as a whole could. The financial profiles of subsidiaries are generally centrally controlled and established on the basis that provides the best tax outcomes, leveraging the balance sheet within the limits provided by Australia's thin capitalisation rules, maximising the rate of interest charged on related party loans and providing payment conditions that allow the capitalisation of interest expense so that it increases on a compounding basis.

In the case of foreign investment in Australia the multinational group has to determine whether the subsidiary will report in Australian dollars or some other currency. Even where it reports its financial statements in Australian dollars the group has to determine whether it will fund the subsidiary in Australian dollars or some other currency. At a group level this

will be driven by where the foreign exchange exposures may arise and where any natural hedges may occur. This will depend on the currency in which an entity derives its income and incurs its expenditure. Many entities (particularly the finance industries and treasury companies) will try to match the currencies of their assets and liabilities, though cross-currency arrangements would be pursued if they offer foreign exchange gains or reduced costs and the associated risks are low or can be effectively managed (for example, where commodities produced by an Australian based multinational are sold in US dollars and the US economy is strengthening relative to the Australian economy or, more generally, if borrowings can be raised more cheaply in another currency). Where a group borrows externally in the currency in which it derives the bulk of its income and provides funding denominated in another currency to its subsidiaries the exchange rate movements will cause one entity to be in loss and the associated counterparty to be in profit to a corresponding extent. Overall the group will be in a breakeven position in relation to the internal funding arrangements but the fact that different entities in the same group hold both sides of the deal creates the possibility that profits in a relatively high tax jurisdiction may be able to be diverted to a low tax jurisdiction by causing the loss to arise in the high tax jurisdiction.

Funding strategies and structures, major financing decisions and internal funding arrangements are unlikely to fall within the remit of the Australian management team, who are more concerned about the solvency and liquidity of the local business operations and the timely provision of sufficient budget for their business plans, rather than whether their funding is provided as debt or equity, in Australian dollars or foreign currency or what the internal interest rate charges are. These decisions are likely to be the domain of the group finance, treasury and taxation teams, though local management may be required to put some of the structural steps in place and do the formal sign off on the transactions.

Subject to the extent to which hedging is used to reduce foreign exchange risk, the exchange rate exposure will result in one party being in a profit position (or "in the money") and the counterparty being in a corresponding loss position (or "out of the money"). Overall it is a zero-sum game. However, where the exchange rate exposure occurs in respect of transactions or arrangements between related parties (sometimes referred to as a "straddle") the group can in some cases financially engineer the loss to arise in Australia and the profit to arise in a low or no tax jurisdiction, in an attempt to reduce the company tax payable in Australia. Such an arrangement may be open to challenge under Australia's transfer pricing rules[99] (or perhaps the general anti-avoidance provisions[100]) if there is no business rationale and evidence of dealings between independent parties dealing at arm's length to support the choice of currency.

The relationship between foreign exchange rates and interest rates is discussed in Chapter 5. Suffice to repeat for present purposes that cash rates and credit spreads can vary significantly from country to country. This may present opportunities for multinational groups to denominate intra-group loans to Australian subsidiaries in currencies of countries that have higher cash rates or business lending rates in an attempt to justify higher interest rate charges to the Australian subsidiary.

The extent to which an Australian subsidiary of a foreign based multinational group is funded with debt and the way in which interest rates are set have significant tax implications. Even

[99] Division 815 of the *Income Tax Assessment Act 1997*.
[100] Part IVA of the *Income Tax Assessment Act 1936*.

marginal differences in interest rates can have a material impact on the profits of the borrowing subsidiary if the related party loans are big enough. If a multinational group was intent on using financial strategies to minimise its tax it would seek to maximise the extent to which it funded its Australian operations with debt and would seek to establish a basis for charging the highest interest rate that it believed could be justified. The financial impact of these arrangements is that tax deductible interest expense is maximised. To the extent that it is excessive relative to what would occur in structures and transactions adopted by independent parties dealing at arm's length with each other, it reduces the subsidiary's taxable income in Australia, subject to Australia's transfer pricing rules. There is ample opportunity in such cases to cause a flow of interest income to an associate in a country where it is either not taxed or is taxed at a very low rate. The recent tightening of thin capitalisation safe harbour ratios for industrial companies from 3:1 to 6:4[101] is likely to prompt even greater exploration of whether there is some basis to charge higher interest rates on intra-group borrowings and a search for a rationale that could be justified under Australia's transfer pricing rules.

In essence, the transfer pricing strategy relies on the creation of high levels of financial risk on the Australian side. The strategy has both structural and transactional elements that are designed to support a synthetic pricing of the loan between the related parties by selecting aspects from the breadth of dealings that occur in dealings between independent parties in the debt markets. The structural elements create the high credit risk profile of the Australian subsidiary which are argued to warrant a low credit rating, well below the credit rating of the ultimate parent company, perhaps even less than investment grade (which would be lower than BBB^{-} using the Standard and Poor's rating scale). The argument to support such a basis of pricing depends on the subsidiary being rated on a stand-alone basis without regard to it being part of a much bigger economic entity, and without regard to the commercial imperative that a group has (and the supporting strategies, policies and procedures it puts in place) to ensure it uses the full strength of its financial profile in order to minimise its cost of debt funding and maximise returns to the parent company's shareholders.

The funding for the subsidiary may be raised from sources external to the group. If so, it will be raised at the lowest possible cost (see Chapter 5). Nevertheless it is open to the group to charge the Australian subsidiary a higher interest rate and the differential in interest rates determines the amount of Australian profits that, in an accounting sense, the group seeks to channel offshore at low or no taxation (see the discussion of interest withholding tax in Chapter 2). The mark-up on the interest rate is entirely an internal matter and does not affect the consolidated financial position of the multinational group. The transfer pricing analysis is somewhat more complex since it requires an examination of the debt funding arrangements between the group entity providing a loan and the borrowing subsidiary on the basis of how independent parties dealing at arm's length with each other would set the conditions in relation to the commercial and financial relations between them.

If the group has sufficient internal funds to provide the loans to the Australian subsidiary the whole of the interest cost charged represents, in an accounting sense, the amount of Australian profits that can be shifted offshore. Again, the arm's length test as articulated in Australia's transfer pricing rules needs to be considered to determine what allowance, if any, should be made on the Australian side for cost of debt funding.

[101] Section 820-195 of the *Income Tax Assessment Act 1997*.

The tax issues relating to the pricing of cross-border debt funding between members of the same multinational group were considered in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) 2015 FCA 1092* and *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation [2017] FCAFC 62* which are discussed in the later part of this Chapter.

The extent to which a multinational group can use debt funding strategies to strip profits out of Australia depends on a number of structural and transactional elements. Decisions by the group on the capital structure of an Australian subsidiary can produce the outcome that the subsidiary is wholly or substantially debt funded. The techniques that multinational groups have for assuring solvency of the subsidiary in such circumstances are discussed in Chapter 8. Another key element is the ways in which the group manages the overall financial risk profile of the subsidiary. These include the setting of the subsidiary's capital structure and the interest charges on related party loans, transfer prices (and margins) for goods and services provided or acquired between group members, the allocation of overhead costs, the conduct of research and development activities and the management of the group's intangible assets. These arrangements may not be the subject of explicit agreements and their nature and effects may need to be discerned from the way business is conducted between group members, the incidence of financial risks for the group members relative to their ability to control them, and whether the accounts and financial statements of the individual entities demonstrate that the parties bearing the financial consequences are obtaining the measure of economic and financial benefits that independent parties dealing at arm's length with each other would expect.

Another structural element facilitating the use of debt funding strategies to strip profits out of Australia is the use of safe harbour debt amounts in the thin capitalisation regime in Division 820 of the *Income Tax Assessment Act 1997* as the basis for determining whether the interest deductions claimed by a taxpayer are excessive. There is an inherent conflict between Australia's thin capitalisation rules and the public policy objective of ensuring that economic profits generated in Australia are taxed in Australia. In its current form Australia's thin capitalisation regime invites profit shifting and condones it subject to the limits it places on interest deductibility through the use of statutory safe harbours. To that extent it is tantamount to a tax concession shielding a portion of the multinational's profits from taxation in Australia. Moreover, the thin capitalisation rules do not prescribe how the interest rate on the debt has to be calculated; that is left to be moderated by Australia's transfer pricing provisions[102], discussed below.

The ability of foreign based multinationals to use debt strategies to increase the level of interest expense that can be claimed against income earned through Australia operations was expanded by the repeal of debt creation rules in Division 16F of the *Income Tax Assessment Act 1936,* leaving the thin capitalisation rules as the primary control on the amount of interest deductions that is allowable for tax purposes.

The analytical point is: the thin capitalisation regime encourages and allows a multinational group to distort the financial profile of Australian subsidiaries or operations, weakening it relative to the way such subsidiaries and operations are generally viewed by the financial markets, which see the Australian subsidiaries and operations as connected to a global value

[102] See TR 2010/7 and sections 815-25 and 815-140 of the *Income Tax Assessment Act 1997*.

chain and the financial strength of the multinational group as a whole. However, it is that weaker financial profile that is reflected in Australia's national accounts.

In a practical sense the statutory safe harbours in the thin capitalisation regime favour foreign based multinational groups over multinationals and domestic corporations based in Australia. This is because of the greater latitude foreign based multinationals have to manipulate the financial profile of their Australian subsidiaries since those financial statements are not determinative of the group's credit rating or in evaluating and managing the economic performance of the Australian operations (see Chapter 8). By contrast, Australian based multinationals rely on their consolidated financial statements to support their credit ratings and to report to the markets on their performance. In other words, the market controls that operate at the parent company level and require multinationals to optimise the balance of their debt and equity funding do not operate at the subsidiary level and consequently Australia's thin capitalisation rules provide a competitive advantage to foreign based multinationals operating in Australia.

This is not to say that the thin capitalisation regime does not provide an incentive for Australian based multinationals to shift profits. Division 820 provides the same safe harbours for outward investing and inward investing entities. The fact that Australia relies on foreign capital means that these groups need offshore finance companies to marshal debt (often in foreign currencies) to on-lend the funds to Australia. Because the offshore subsidiary is designed as a financing conduit it is likely to be established, in a jurisdiction that does not tax the interest income the subsidiary receives from on-lending. There is a commercial rationale to this since that interest income flow is needed to service the external borrowings the subsidiary has raised and the margin between the interest income it receives and the interest expense may produce little if any profit. However, these commercial arrangements present the opportunity to shift profits to the offshore subsidiary by charging a higher margin, which would be argued to constitute part of the active business income that is not subject to attribution back to Australia as assessable income under the Controlled Foreign Company rules in Part X of the Income Tax Assessment Act 1936 because the offshore subsidiary is carrying on a business of moneylending. Nor would the internal flows be neutralised by Australia's tax consolidation regime because membership of such groups is restricted to Australian resident entities[103]. There would need to be some commercial basis that the group could use as a justification for the subsidiary to charge the Australian operations a margin over and above its own cost of funds. The profits accumulating in the offshore subsidiary could be loaned back to Australia at interest or paid back by way of a tax-exempt dividend under section 23AJ of the *Income Tax Assessment Act 1936*.

Australia's imputation system (discussed in Chapter 2) and the transfer pricing rules formerly in Division 13 of the *Income Tax Assessment Act 1936* and now in Division 815 of the *Income Tax Assessment Act 1997* can have a moderating effect on such strategies, including sections 815-25 and 815-140 which require that interest rates be calculated on an arm's length basis, which is then applied to the level of debt allowed by the thin capitalisation rules. Nevertheless, the point remains that the thin capitalisation regime has a debateable public policy basis. If tax policy settings were impeding Australia's ability to obtain foreign investment capital or inflating the market cost of capital - which seems unlikely given the fundamental design of Australia's company tax and withholding tax regimes - it would be

[103] Subsection 703-15(2) of the *Income Tax Assessment Act 1997*.

preferable to use company tax rate movements than to continue to distort profit reporting for tax purposes.

The market access and cost of funding advantages that generally flow from a multinational group using its full economic strength and profile to support external borrowings, and the implications for its existing financial covenants and the possibility of further covenants, are strong grounds for multinationals to tightly control all aspects of external group funding. The commercial imperative is for multinationals to allow a subsidiary to borrow direct from independent external parties only if there is an advantage to the group in doing so, and certainly not if the costs exceed those that the group can obtain.

Where an authorised subsidiary seeks to raise debt funding, trade credit or overdraft facilities, debt markets and independent lenders like financial institutions have regard to the fact that the subsidiary is part of a corporate group (see Chapter 5). This is generally referred to as the process of affiliation through which rating agencies and lenders consider whether the stand-alone credit rating of a subsidiary should be notched up or down due to the financial position and profile of the group and the likelihood that the group (through parental guarantee, formally binding letter of comfort, due to the core or strategic significance of the subsidiary, because of legal sanctions, reputational risk or for other reasons) will support the subsidiary in the event of a default.

Branches of companies forming a multinational group depend on the financial structure and profile of the company of which they are a branch, and the markets will consider those companies in the context of the multinational group to which they belong. A special global regulatory framework has been developed for the offshore operations of banks, with the home jurisdiction being responsible for prudential supervision, including the assurance of adequate global capital to cover market and operational risks in all the jurisdictions in which the bank operates[104].

The Chevron Case

An example of how the capital structuring of an Australian subsidiary and the setting of intra-group interest rates between the Australian entity and an offshore associated entity can be established in an attempt to provide tax and cashflow advantages is set out in paragraphs 104-126 of Robertson J's judgment in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) 2015 FCA 1092*. (See also the earlier discussion in Chapter 3 of the global tax planning structures that are available to multinational groups.) The case deals with a number of important constitutional and administrative law points and key aspects of the rules of evidence, but these are not relevant for the purposes of the present discussion regarding the alignment between tax law and the real world business environment in which it has to operate.

The strategic significance of the *Chevron Case* and the *SNF (Australia) Case* discussed in this section and Chapter 10 is that they provide the backdrop for the changes to Australia's transfer pricing laws and the *Chevron Case* allows an opportunity to consider an aspect of the transition from old law to newer law (Subdivision 815-B, C and D being the newest law),

[104] This framework is known as the Basel Accord, overseen by the Basel Committee comprising 45 members from 28 jurisdictions. Further information is available on the Bank for International Settlements website.

namely the pricing of intra-group transactions. No doubt other test cases will explore whether Subdivision 815-A and Division 815 in its current form are effective in not only addressing non-arm's length pricing of transactions but also in putting non-arm's length structures onto an arm's length footing for tax purposes by the adoption of the relevant arm's length conditions in lieu of the offending conditions so that the outcomes of those structures are arm's length and Australian taxation is based on the economic value created by the Australian operations, due allowance being made for tax reconciliation adjustments allowed by the law.

The historical facts relating to the corporate financing aspects of the *Chevron Case* are set out in paragraphs 97 to 104, 113 and 160 of Robertson J's judgment. There is a convenient summary of those facts and the relevant tax impacts of the funding strategy in Pagone J's judgment in the appeal hearing ([2017] FCAFC 62 at paragraphs 100 and 101). Details of the terms of the Credit Facility Agreement are set out in of the judgment of Allsop CJ in the appeal ([2017] FCAFC 62 at paragraphs 22-34). Essentially, there was a restructure and refinancing of the Australian group holdings following the merger on 10 October 2001between 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. CAHPL established a wholly owned subsidiary, Chevron Texaco Funding Corporation (CFC) in the US to issue commercial paper denominated in US dollars which was said to be for the purpose of funding for the Australian sub-group. To raise money in the commercial paper market CFC needed a guarantee from Chevron Corporation (paragraph 138 of Robertson J's judgment) and this ensured that the commercial paper was rated by the credit rating agencies as highly as possible (paragraph 108 of Robertson J's judgment). CFC raised $US 2.5 billion at an interest rate of around 1.2% with the benefit of the guarantee provided by the ultimate parent. A Credit Facility Agreement was executed between CFC and its parent CAPHL on 6 June 2003 and CFC on-lent to CAHPL in Australian dollars at an interest rate of 9% in two drawdowns. The first drawdown on 6 June 2003 was for the Australian dollar equivalent of $US1.45 billion and the second on 26 August 2003 was for the Australian dollar equivalent of $US1.0 billion. As part of the restructure of the Australian operations of the two merged entities there was a return of capital to the US and CAHPL acquired the Australian assets of Chevron and Texaco. The purpose of the loans was to provide funding for those events (paragraph 113 of Robertson J's judgment). In other words, all the transactions on the Australian side were internal to the Chevron group and would wash out on consolidation of the Chevron Group's accounts.

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 particular Mr David Krattebol, Global Treasurer of Chevron and a director of CFC[105].

It was established in evidence before Robertson J that CAHPL did not have any of its directors on the board of CFC; that CFC did not have any staff of its own; that Chevron Treasury had the lion's share of the management of CFC; that all of the activities that resulted in CFC doing anything were originated from Chevron Treasury in the US; that the decisions that were made by CFC were made by Chevron Treasury staff; and that CAHPL was not involved in the commercial paper raising in the United States[106]. All of this aligns

[105] [2015] FCA 1092 at paragraphs121 and 165; [2017] FCAFC62 at paragraph 20 per Allsop CJ.
[106] [2015] FCA 1092 at paragraph119.

with the integrated centralised control of group treasuries and group financing discussed in the earlier part of this Chapter, and confirmed in evidence by Ms Taherian who was employed by the Chevron Treasury[107], and suggests CFC was operated as a Chevron Treasury company despite its formal legal status as a subsidiary of CAHPL.

It appears that the net increment to the Chevron Group funding provided by the issue of commercial paper was used by the US part of the group. One can imagine there were no doubt sound commercial reasons for the Chevron Group to raise additional debt through the issue of commercial paper but it would not be possible to ascertain those needs without access to the full picture of group funding requirements, the approved sourcing and application of funds, being managed by the Chevron Group Treasury.

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. Section 3.3 of the Credit Facility Agreement provided that the principal of each Advance was to be paid on the Maturity Date (30 June 2008 but later extended to 29 December 2010) and interest monthly in arrears in Australian dollars.

It is not clear from the court reports whether CFC had an AUD account or whether bank records show that there were actual flows of AUD between CFC and CAHPL when each of the drawdowns were made under the Credit Facility Agreement. Such evidence would be particularly relevant from a tax administration perspective given the transactions on the Australian side were all internal to the Chevron Group and did not require external funding.

It appears that the foreign exchange risk was allocated to Australia through the stipulation of a USD2.5 billion currency limit in the Credit Facility and the provision of funding to CAHPL in "the aggregate equivalent in Australian dollars"[108]. To the extent that CAHPL was able to derive income in USD (for example through gas sales outside of Australia) it was naturally hedged. While CAHPL's USD account appears to have had more than sufficient funds to cover the repayment of principal and interest on 29 December 2010, as will be seen below the repayment was financed by a loan from another group company. The US part of the Chevron Group which actually used the additional externally raised funding also appears to have been naturally hedged against foreign exchange risk since its products were sold in US dollars and its expenses were also in US dollars. The Chevron Group as a whole was also naturally hedged in relation to the repayment of the amounts raised by CFC through the issue of commercial paper.

The fairly lengthy term of the Credit Facility also raises issues regarding foreign exchange risk. The Australian side of the operations was exposed to foreign exchange movements from the time of the original drawdowns on 6 June and 26 August 2003 to 29 December 2010 when the principal amount was ultimately repaid[109]. Yet there was no discussion between the parties as to the currency of the loan[110] or the management of the exchange rate risk (which no-one appears to have been managing for CAHPL).

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[107] [2015] FCA 1092 at paragraphs 143 and 154.
[108] [2015] FCA 1092 at paragraph 2.
[109] [2015] FCA 1092 at paragraph 118.
[110] [2015] FCA 1092 at paragraph 120.

There is no discussion in the case reports of any change to the USD2.5 billion limit on the Credit Facility Agreement. However, the evidence as found by Robertson J at first instance was that a principal amount of AUD3,707,168,685.25 was repaid on 29 December 2010, which was the equivalent at the time of USD3.75 billion, suggesting the AUD and USD were close to par at that time, but the amount debited to CAHPL's USD bank account was USD3.84 billion[111], which was itemised as comprising:

USD3,746,464,673.31 (being the USD equivalent of AUD3,707,168,685.25)
USD 22,499,081.39 (being an interest payment equivalent) and
USD 71,036,245.30 (being an overpayment).

There is no information in the court reports as to whether the payment of AUD3,707,168,685.25 included any element related to foreign exchange movements. The overpayment is not explained, nor whether any taxation implications arose in respect of it.

The evidence from Mr Dalzell, a director of CAHPL[112], was that the interest rate was set by the group Treasury[113], it was calculated by reference to the AUD principal amounts borrowed and that the initial interest payments were funded with short-term interest free loans from Chevron Overseas Petroleum Inc[114], and there was the specific payment of interest on 29 December 2010. It appears that, since the loans were not amortising, the effect of the arrangements was that interest expense on the full amount of the borrowings was in effect capitalised over the lives of the loans, reflected in the higher USD repayment amount relative to the USD2.5 billion limit on the Credit Facility Agreement. This is something that would be unlikely to occur in dealings between independent parties dealing at arm's length with each other.

The arrangements put in place by the group suggest that CAHPL was not financially self-sufficient or creditworthy on a stand-alone basis and would not have been able to borrow the equivalent of USD2.5 billion without parental support. In fact the evidence was that the borrowing of USD2.5 billion in AUD at an interest rate of 8.9% was not sustainable if CAHPL had not received any dividends from profits accumulated in CFC as a result of the interest rate margin charged to CAHPL[115]. The related party funding to cover interest payments and the effective capitalisation of the interest obligations add weight to that view. 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[116]. It was the financial strength of the Chevron group as a whole and the provision of a parental guarantee that enabled the external borrowing to be made and the relative financial fragility of CAHPL was not significant in that context.

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 and successively on the capitalisation of each interest obligation accrued on the initial drawdowns. This financing strategy increased the leverage in CAHPL's balance sheet and progressively increased the tax deductions for interest expense.

[111] [2015] FCA 1092 at paragraph 118.
[112] [2015] FCA 1092 at paragraph 106.
[113] [2015] FCA 1092 at paragraph 124.
[114] [2015] FCA 1092 at paragraph 117.
[115] [2015] FCA 1092 at paragraph 125.
[116] [2015] FCA 1092 at paragraph 165.

Since the repayment of USD3,746,464,673.31 on 29 December 2010 was funded internally by a borrowing from CAHPL's immediate parent company Chevron Australia Petroleum Company under the terms of a credit agreement dated 17 November 2009[117], the amount of debt funding in CAHPL's balance sheet was maintained at the increased level, including through the capitalisation of interest.

The evidence before Robertson J established that while the directors of CAHPL formally approved the Credit Facility Agreement and opened bank accounts[118], 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 issue in the US[119].

According to the evidence of Mr Dalzell, a director of CAHPL and having responsibility for the department that covered Treasury, finance, taxation and compliance for the Australian operations of the Chevron group[120], CAHPL's debt level of USD 2.5 billion was chosen to achieve the most tax efficient capital structure for CAHPL[121]. CFC was not taxable in the United States on the interest income it received from CAHPL[122] and was able to derive profits on the margin between its borrowing costs and the higher interest rate it charged to CAHPL. The interest paid to CFC was also free from Australian interest withholding tax[123] (see the discussion of Australia's interest withholding tax regime in Chapter 2). CFC returned its profits to its Australian parent, CAHPL, by way of dividends which were exempt from Australian tax[124] under section 23AJ of the *Income Tax Assessment Act 1936* (see the overview in Chapter 2 of Australia's framework for taxing foreign direct investment).

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[125]. The actual inferences drawn by Robertson J from the body of evidence are set out below in the summary of his rationale for judgment.

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. This had the effect of changing the nature of the borrowing to be priced from wholesale debt funding to a party to party loan;

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117 [2015] FCA 1092 at paragraph 118.
118 [2015] FCA 1092 at paragraph 117.
119 [2015] FCA 1092 at paragraph 121; [2017] FCAFC62 at paragraph 20 per Allsop CJ.
120 [2015] FCA 1092 at paragraph 106.
121 [2015] FCA 1092 at paragraph 121.
122 [2015] FCA 1092 at paragraphs 126 and 147.
123 [2015] FCA 1092 at paragraph 107.
124 [2015] FCA 1092 at paragraphs 126.
125 [2015] FCA 1092 at paragraph 165.

(iii) Despite the fact that all these arrangements were internal to the Chevron group, using CFC to raise external funding of USD2.5 billion and on-lend it to CAHPL to cause the cost of the external funding to be attributed to Australia and ensure that interest payments made from CAHPL to CFC were 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 to support a high interest rate charge;

(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[126]. 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 over the 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 and transactional elements that each contributed to the maximisation of the tax deductible interest expense incurred in Australia, while ensuring the interest flow was not taxable in the US, or in Australia when CFC's net interest income was repatriated in the form of dividends.

No assessing action was taken by the Commissioner in reliance on the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* in relation to income tax or interest withholding tax. It is not known as to whether there was any misleading conduct in relation to the connection between the raising of the external funding and the financing of what were internal transactions affecting the Australian side that might override the statutory time limits for amendment action by the Commissioner.

It would be expected, having regard to the discussion of economic value chains in Chapter 2, that the arrangements for the purchase of significant amounts of plant and equipment for the build of the Chevron operations in Australia and the marketing arrangements for the significant volumes of products produced by those operations would be economically material aspects of Chevron's Australian operations. It is not known whether the group was using procurement and marketing hubs and, if so, whether any margins allowed to those hubs were arm's length. Nor is it known whether the plant and equipment was purchased in AUD.

The only transfer pricing issue that has before the Court was whether the ≈9% interest rate charged on the loans to CAHPL exceeded the consideration that would have been agreed between independent parties dealing wholly independently with each other. This same issue arose regardless of whether the domestic transfer pricing provisions in Division 13 of the

[126] Part X of the *Income Tax Assessment Act 1936.* (See also the summary of Australia's regime for taxing foreign direct investment in Chapter 2.)

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 were being applied, though the formulation of the arguments is quite different. Were the issue to arise in a current year assessment it would now have to be considered in the context of Subdivision 815-B.

In relation to the application of Division 13 – and in particular section 136AD(3) and section 136AA(3)(d) – the statutory question, in so far as presently relevant, is framed in terms of the taxpayer having acquired property under an international agreement and whether a taxpayer gave or agreed to give consideration in respect of the acquisition in an amount that exceeded the arm's length consideration. Section 136AA(3)(d) provided that a reference to the arm's length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition.

The question that arises under Subdivision 815-A is whether, having regard to the operation of the Subdivision in incorporating the Associated Enterprises Article of the US Convention by reference, non-arm's length conditions operated in the commercial or financial relations between CAHPL (an enterprise of Australia) and an enterprise of the United States and resulted in CAHPL getting a transfer pricing benefit in that an amount of profit did not accrue in Australia but would have accrued if arm's length conditions operated. If so, section 815-30 allows the Commissioner to negate the transfer pricing benefit. In the facts and circumstances of the case the "conditions" presented to the Court by the Commissioner as having this effect included the interest rate set on the loans between CFC and CAHPL[127], which was adjusted in the amended assessments that were before the Court, the actual interest rate being argued to be excessive relative to what would have occurred if the loans had been between independent parties dealing at arm's length with each other.

A common feature of Division 13 and Subdivision 815-A is the concept of "independent parties dealing wholly independently with each other", albeit those provisions each use the concept in a different context. This concept has also been incorporated into the legislative frameworks of Subdivisions 815-B, C and D, again a different legislative context. Nevertheless, there are common insights that can be derived and given its ongoing significance it is important to reflect on the observations on that concept made by the Federal Court in the *Chevron Case* and the *SNF (Australia) Case*, though it bears repeating that the legislative frameworks of Division 13 and Division 815, in which that concept operates, differ in important respects.

[127] [2015] FCA 1092 at paragraphs 582, 590 and 614

The application of Division 13 in the Chevron Case

Chevron argued in relation to the terms of Division 13:

(i) The particular property in fact acquired was the bundle of rights conferred by the Credit Facility Agreement, namely rights to borrow a sum expressed in Australian dollars, and it was not open to the Commissioner to challenge the commercial choice to prefer Australian dollars. The features going to the essential nature of the property acquired, said to arise by virtue of the Credit Facility Agreement, were the quantum of the loan being the AUD equivalent of USD 2.5 billion, the five year term, the absence of any onerous financial covenants, the loan was unsecured, the loan was non-amortising, and the currency of the loan was AUD;

(ii) The benchmarking of the actual consideration against the consideration that might reasonably be expected to have been given by independent parties required the removal of all the connections between the actual parties in the hypothesis or comparison, namely that CAHPL was the parent of CFC and that both companies were subsidiaries of Chevron Corporation. However, the characteristics of the borrower that affected its creditworthiness and hence the pricing of the loan must be taken into account but the assets, risks and functions of CAHPL to be attributed in this inquiry were those of CAHPL as a stand-alone entity. This must exclude implicit support from the borrower's affiliation with its ultimate parent because such support or credit benefit emanated from the non-arm's length relationship. The closest analogue was an institutional loan known as a "Term Loan B and, while the loan lacked some of those features, there was sufficient global market capacity to place the loan provided it was appropriately priced for additional amounts institutional investors would charge for the increased risk; and

(iii)No investigation or consideration of motive or purpose for the actual acquisition was warranted by section 136AD(3).

(Paragraphs 481-489 of Robertson J's judgment.)

The Commissioner argued:

(i) The Credit Facility Agreement was not one that would be entered into between independent parties dealing with each other at arm's length. Chevron's case was effectively that CAHPL was a considerably uncreditworthy borrower, one in the speculative category, and this would lead any lender to demand a very high rate of interest, if indeed any lender was prepared to lend;

(ii) Sections 136AD and 136AA ask what form an agreement might have taken if it had been negotiated by entities dealing with each other at arm's length. Section 136AA(3)(d) provides that a reference to the arm's length consideration in respect of the acquisition is a reference to the consideration that might reasonably be expected to have been given or agreed to be given if the property had been acquired under ***an agreement between independent parties*** dealing at arm's length with each other in relation to the acquisition. It

would defy not only the language, but also the purpose of the transfer pricing legislation to permit only the price under a non-arm's length agreement to be altered despite the agreement's other non-arm's length terms. A multinational enterprise could insert various unattractive and unrealistic terms in its related party agreements, terms which are commercially meaningless to it because of the pre-existing relationship between the parties, and serve only to increase the price for tax purposes;

(iii) The correct approach was that all the facts and circumstances of the parties (other than their non-arm's length relationship) be imported into the hypothetical parties, thus avoiding speculation. It was necessary to have regard to CAHPL's status as a subsidiary of a much bigger group and the group's financial strategy of minimising its external borrowing costs. If a company in the position of CAHPL were borrowing from an independent party, its parent would have provided a guarantee of the borrowing;

(iv) The loan should have been denominated in US dollars. The interest rate should have been the USD rate applicable to a AA rated borrower, or alternatively a borrower rated in the A range. Alternatively, if the Court were of the view that the loan could be denominated in AUD the interest rate should have been the AUD rate for a AA rated borrower;

(v) Alternatively, if the Court was of the view, which the Commissioner disputed, that the borrower was to be regarded as a stand-alone company the interest rate should be the USD rate applicable to a BBB rated borrower (on the basis that CAHPL would have borrowed less – USD1.7 billion – in order to obtain an investment grade credit rating), or another rate based on the evidence the Commissioner argued reflected comparable uncontrolled transactions, or 5.38% based on the analysis Goldman Sachs undertook for Chevron.

(Paragraphs 495-496 and 498-499 of Robertson J's judgment.)

It is noted that the Commissioner's submissions in relation to interest rates based on AUD borrowings as reflected in the judgment were not as comprehensive as the alternatives the Commissioner presented in relation to interest rates based on USD borrowings.

At both first instance and on appeal the Federal Court held that the interest rate paid by CAHPL exceeded the arm's length consideration for the purposes of Division 13.

At first instance Robertson J held:

> 73. In my opinion the property CAHPL acquired under the international agreement, the Credit Facility Agreement, was the rights or benefits granted or conferred under that Credit Facility, including the sums lent.
>
> 76 What is required, in my opinion, [in applying Division 13] is to depersonalise the agreement to acquire so as to make it, hypothetically, between independent parties dealing at arm's length, but not so as to alter the property acquired. Division13 of the ITAA 1936 does not, in my opinion, require or authorise the creation of an agreement with terms different from those of the actual agreement, other than the consideration.

78. It is not enough, in my opinion, to proceed on the basis that the hypothetical independent parties would not have made an agreement on the same terms.

79. One issue of statutory construction between the parties was whether section 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 be to use the word "independent" as if it meant entirely independent rather than, in a case such as the present, independent of the lender.

80. 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 (E&P) subsidiary.

81. 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.

82. Implicit in this approach is that the word "consideration" in s.136AA(3)(d), which is not exhaustively defined but is extended by s136AA(3)(b), should not be taken to mean more than it otherwise would, in context. This means that I do not construe "consideration" in s136AA(3)(d) to mean the terms of the contract which do no more than affect the interest rate. For example, although the interest rate will be affected by the financial viability of the borrower, I do not construe the word "consideration" as extending to those characteristics.

84. In my opinion, neither the context provided by s136AD(3) nor the non-inclusive definition of "consideration" in s136AA(3) provides a basis for concluding that the word "consideration" is limited, in the case of a loan, to the interest rate. Insofar as the applicant contended otherwise, I reject that submission.

87. Applying ss136AD(3) and 136AA(3) of the ITAA 1936 in the present case, I accept that the promises by the borrower, CAHPL, were the consideration given or agreed to be given by it. I also accept that the wide definitions of "agreement" and of "acquire" in s136AA(1) mean that the acquisition of property by a taxpayer under an international agreement is not limited to acquisitions made pursuant to contract. In the present case I find that CAHPL did not give security or operational and financial covenants, which would have affected that part of the consideration which was the interest rate: the interest rate was higher in the absence of those promises or covenants. If the property [the moneys advanced by way of loans] had been acquired under an agreement between independent parties dealing at arm's length with each other, I find that the borrower would have given…security and operational and financial covenants and the interest rate, as a consequence, would have been lower. The limited scope of consideration….resulted in the consideration which CAHPL did give….exceeding the arm's length consideration….It follows, on that basis, that the applicant [Chevron] has not shown that the arm's length consideration assessed by the respondent Commissioner was excessive.

> 88. However, in my opinion, s136AD does not require or allow a different agreement to be substituted, on the basis that two independent parties would not have entered into a loan agreement on the same terms as the Credit Facility Agreement. It is not, therefore, an appropriate approach under Div 13 of the ITAA 1936 to ask what terms, other than the consideration, would have been if CAHPL had been negotiating with a third party lender unrelated to it or if two unrelated parties neither of whom was CAHPL or CFC had been negotiating.
>
> 165. I infer from the evidence that the objectives of the leveraging project were to obtain the lowest cost of funding and to achieve merger synergy objectives, including the tax benefits that would arise from the gearing of the balance sheet of the Australasian Business Unit. I also infer from the evidence that CAHPL's debt level of USD2.5 billion was chosen because it was the most tax efficient corporate capital structure and gave the best after-tax result for the Chevron group. I further infer 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.
>
> [See also his Honour's further reasoning at paragraph 525, which has been set out below.]

The following observations may be made in relation to his Honour's reasoning in relation to the operation of Division 13. First, his Honour appears to have formed the view (expressed in paragraph 82) that the statutory mechanism used in Division 13 did not allow him to have regard to the financial circumstances of the taxpayer when considering whether the interest rate (the consideration) for the loans was the rate that would have been set by independent parties dealing at arm's length with each other. His view seems to have been influenced by his interpretation of the earlier Federal Court decision in the *SNF (Australia) Case*[128] (discussed in detail in Chapter 10) where the court decided its task under Division 13 was akin to determining the market price for the imported products, irrespective of the financial impact that the payment of that price would have on the profitability of the purchaser. At first instance in the *SNF (Australia)* Case Middleton J expressed this aspect in the following terms:

> 41. Section 136AD(3)(c) is concerned with the consideration in respect of the acquisition of particular property. The proper application of s136AD requires that the deemed arm's length consideration be determined in respect of the acquisition of the particular property by considering the arm's length consideration as "an objective fact in the real world": see *WR Carpenter Holdings Pty Ltd v Commissioner of Taxation* (2006) 234 ALR 451 at [20] per Lingren J.
>
> 42. In applying s136AD(3)(c) the Court is looking to consider whether the consideration applicable to the particular acquisition was the arm's length consideration. In general terms, this is the consideration that might, on an analysis of all relevant available evidence, reasonably be expected to have passed between independent parties dealing at arm's length with each other in relation to the acquisition.
>
> ………..

[128] *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.

> 44. 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 for the products. The essential task is to determine the arm's length consideration in respect of the acquisition………..
> 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……(emphasis added)

The decision of the Full Federal Court on appeal ([2011] FCAFC 74 per Ryan, Jessup and Perram JJ) confirmed Middleton J's approach that affordability of the market price was irrelevant. In the context of their deliberations about comparability in the process of determining arm's length prices their Honours said:

> 97. The critical words of s136AA(3)(d) in question are "between independent parties dealing at arm's length". It is the burden of the Commissioner's argument that one of the independent parties to whom the provision refers must necessarily be the taxpayer. That observation lays bare an ambiguity in the expression "independent parties at arm's length". In the context of s136AD(3) and s136AA(3)(d) those words could equally cover any of the following three situations:
>
> (a) a purchase by the taxpayer from a hypothetical arm's length supplier;
> (b) a purchase by a hypothetical purchaser from the taxpayer's actual supplier;
> (c) a purchase by a hypothetical purchaser from a hypothetical arm's length supplier.
>
> 98. That ambiguity underscores the fact that 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 thus disclosed is a relative one. Generally speaking a statement that two parties have a relative connection of a particular kind does not carry with it any information about their absolute status…it would be unsound to read it as requiring any more than that the two parties in question should be independent of each other….

The argument, considered in both the *SNF (Australia) Case* and the *Chevron Case* that the concept of "independent parties dealing at arm's length with each other" appearing in Division 13 and Australia's double taxation treaties requires a subsidiary of a multinational group to be regarded as a stand-alone entity strays outside the statutory purpose of that concept and relies on a statutory deeming or postulation that is not expressed in, required by or appropriate to the operation of the Division or the treaties. It appears to be a kind of wishful thinking by tax planners that the legislation, contrary to its own purpose, requires the parlous circumstances of a subsidiary that can be contrived by the multinational group to be taken as the basis for determining arm's length interest rates on related party cross-border loans. It is difficult to see how a contrived non-arm's length starting point, namely the fragile capital structure, financial profile and non-arm's length credit facility created by Chevron's group treasury for CAHPL, could ever be the basis for determining an arm's length price for a related party loan. As an objective fact in the real world a subsidiary company is not a stand-alone entity completely independent of its parent. The multinational groups in each of those cases did not give their subsidiaries that authority and did not establish or operate them as separate profit centres. Moreover, the taxpayers in each of those cases did not appear to have been able to operate on a financially independent basis and required ongoing financial support from the group.

The argument that the term "independent parties" in the context of the statutory language of "independent parties dealing at arm's length with each other" should be read as parties that are entirely separate and not subsidiaries, was described by the Full Court in the *SNF Case* as "unsound". Accordingly, a tax avoidance strategy that depends on the rationale that a subsidiary of a multinational group should be regarded as a stand-alone entity for the purposes of the arm's length test as articulated in either Division 13 or Division 815 is not legally sound, and the use of that rationale as a basis for pricing a related party cross-border loan, does not appear to be reasonably arguable for the purposes of the penalty provisions in Subdivision 284-A of Schedule 1 of the *Taxation Administration Act 1953*, and certainly not after the decisions in the *SNF* and *Chevron Cases.* Subsection 284-15(1) provides:

> A matter is ***reasonably arguable*** if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.

In relation to the relevance of the financial circumstances of the parties engaged in arm's length dealings, there does seem to be a fundamental difference between the pricing of a good in independent dealings in the global market and the setting of interest rates between independent parties dealing at arm's length from each other in relation to an AUD equivalent loan of USD2.5 billion, which will depend on the relative creditworthiness of prospective borrowers that are in fact creditworthy. The creditworthiness of a prospective borrower, which is dependent on its financial profile and affiliations, is central to the practice of independent lenders dealing at arm's length with independent borrowers in the competitive market system in deciding whether or not to lend and in pricing their loans. His Honour seems to acknowledge this at paragraphs 81, 82, 501 and 502 of his judgment where he says that the interest rate on a loan will change depending on the creditworthiness of the borrower, its capacity to repay and the likelihood that it would do so and that it is relevant to take such matters into account in applying s136AD.

This recognition of market practice also seemed to influence the rationale for the arguments put by both the taxpayer and the Commissioner in the *Chevron Case*, the difference being that the taxpayer argued this should be assessed on the basis that CAHPL is a stand-alone entity while the Commissioner argued that the credit standing of CAHPL should be assessed on the basis that it was affiliated with the Chevron group.

However, his Honour was clearly influenced by the observations in paragraph 41 of Middleton J's judgment and paragraphs 97 and 98 of the Full Court decision in the *SNF (Australia) Case* as requiring him to apply the arm's length hypothesis in Division 13 to establish the arm's length consideration as an objective fact that is not coloured by importing the financial circumstances of the taxpayer and whether the taxpayer can afford the arm's length price into the hypothesis. There seems to be a potential tension between an approach that disregards the circumstances of CAHPL and the findings in both the *SNF (Australia) Case* and Robertson J's judgment that the arm's length test in Division 13 did not require the taxpayer to be regarded as a completely stand-alone entity. In fact at paragraphs 501 to 503 of his judgment Robertson J states:

> 501…..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. [Note that in paragraph 80 of his judgment his Honour also refers to the relevance of a borrower being a subsidiary.]
>
> 502 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 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.
>
> 503. Applying these general considerations t 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.
>
> [Emphasis added.]

Robertson J did not express a view on whether the amounts of interest expenses determined by the Commissioner in the amended assessments were in fact the arm's length considerations for the loans in the relevant income years. His Honour explained in his judgment that:

> 480 I approach this question [of consideration for the purposes of Division 13] in light of the reasoning of the Full Court in *SNF* 193 FCR 149 at [128] as follows, recognising that in that case the Commissioner had made a determination under s136AD(4) whereas in the present case he has not:
>
> > Of course, it is true that s136AD operates to engage the statutory fiction that the consideration paid was "the arm's length consideration" and that the existence of more than one such value may give rise to practical problems of administration. But it is precisely to situations of that kind that the Commissioner's power conferred by s136AD(4), to determine the arm's length consideration, is apposite: "where for any reason (including an insufficiency of information available to the Commissioner), it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration…..[it] shall be deemed to be such amount as the Commissioner determines". Where there is more than one arm's length price (as often there will be) the Commissioner may determine which he will apply. Correspondingly, in review proceedings the taxpayer will be entitled to succeed if it shows that the prices paid by it were arm's length prices or less than arm's length prices. If it pursues the latter course there is no need for it to establish a particular price is *the* arm's length price. It will be sufficient to show that it paid less than *an* arm's length price.

Chevron argued that it had paid less than the arm's length price. Paragraph 87 of Robertson J's judgment reflects his findings that security and other covenants would have been provided

in arm's length dealings and the limited consideration given by the taxpayer resulted in the consideration which CAHPL did give exceeding the arm's length consideration. (He does not say by how much.) 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[129]. At paragraph 525 of his judgment, after rejecting comparables and methodologies proffered by Chevron, his Honour states:

> 525 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…….

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, as discussed in Chapter 5 and earlier in this Chapter in relation to security, 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 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 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 if it so chose and have full flexibility to deal with CAHPL's cashflows and solvency.

Another potential difficulty for CAHPL is that a lender may not find a security offered by CAHPL suitable in terms of their 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 remote assets and their value to a large extent depended on the success of the gas production operations.

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[129] 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.

Robertson J took the view that "implicit support" may be generally relevant when assessing a borrower's credit rating[130]. 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"[131]. The need for a parental guarantee of subsidiary borrowings was standard practice in the wholesale finance markets, as seen with the USD2.5 billion commercial paper issue in the US undertaken by CFC, the reasons already discussed in Chapter 5 and the earlier part of this Chapter.

On the facts as found in the case one could make an even more fundamental point. The poor financial position of CAHPL is evident from the facts as found by his Honour. The subsidiary does not appear to be viable on a stand-alone basis. It needed funding support to meet its interest commitments. Accordingly, it is likely 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. In the facts and circumstances of the case this additional security appears to have been necessary in order to access debt funding from an independent party, 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.

The view that the statutory definition of the "arm's length consideration" in s136AA(3)(d) did not require that the borrower as an independent party be considered as a stand-alone company (paragraph 72), which aligns with the approach taken by the Full Federal Court in the *SNF (Australia) Case* (cited above), also contradicts a key step in the rationale advanced by the taxpayer in support of its tax planning strategy; namely, that the arm's length test as articulated in Division 13 and in Australia's tax treaties (and now in Division 815) requires a hypothesis involving parties that are entirely independent, which enables multinational groups to create a very weak financial profile for subsidiaries on a stand-alone basis to justify high interest rate charges on related party cross-border loans.

The Commissioner argued that if a company in the position of CAHPL were borrowing from an independent party its ultimate parent would have provided a guarantee. On the assumption that the borrower was "stand-alone" the Commissioner argued that the borrower would have provided covenants and security, or have borrowed less and raised the balance by way of equity. (Paragraphs 496 and 497)

His Honour formed the view that in that context CAHPL would have provided security and operational and financial covenants and obtained a lower interest rate from an independent lender. One needs to make the caveat that his Honour did not define what he meant by security, operational and financial covenants. However, one might be tempted to infer from this that he may not have been comfortable with the suggestion that the ultimate parent company would have provided a guarantee, a position explicitly put before the Court by the Commissioner (Paragraph 496). His analysis is open to the reading that he is confining the frame of reference for the transfer pricing analysis to CAHPL and what it could and would do on its own in borrowing from an independent external lender. Were this to be an accurate reading of his approach it excludes from the hypothetical a number of elements that are characteristic of multinational group financing and treasury operations designed to use the group's collective financial strength to minimise the group's WACC (and hence each

[130] [2015] FCA 1092 at paragraph 605.
[131] [2015] FCA 1092 at paragraph 606.

subsidiary's cost of any external borrowings) and thereby maximise the group's ROE and EPS. (See the earlier discussion in Chapter 5 of the strategic significance and interrelationship of WACC, ROE and EPS.) It also presents the difficulty that there may have been nothing that CAHPL could have promised as security that would have satisfied an independent commercial lender to advance the funds because CAHPL was not creditworthy in its own right.

While in open market dealings it may be debated as to what allowance a commercial lender would make for the subsidiary's group affiliation in the context of deciding whether to lend and, if so, at what price, there was the clear probability that CAHPL could obtain the funding and would obtain a lower interest rate in respect of the loan if its ultimate parent provided a guarantee, as it had done for CFC in relation to the issue of commercial paper. However, despite the evidence that the group had a policy of obtaining external debt at the lowest possible cost and providing guarantees to achieve that outcome his Honour does not appear prepared to take that likelihood into account in the context of Division 13. The Commissioner had argued that the rationale ultimately adopted by his Honour would be appropriate if CAHPL was required by Division 13 to be considered on a stand-alone basis. While his Honour found that the arm's length hypothetical in section 136AD(3) did not require parties in the hypothesis to be entirely independent, merely independent of each other, his Honour may have taken the view that the consideration that was the subject of the hypothesis in s136AD(3)(d) was the consideration provided by the borrower, CAHPL as a group subsidiary in this case, and that it therefore excluded consideration that could be provided by a parent company in order to reduce the consideration paid by the borrower. He may have read the definition of "arm's length consideration" in subsection 136AA(3)(d) as confined to the bilateral context of the borrower and an independent lender. Paragraph 87 of his judgment tends to indicate this may have been his approach despite his findings that it was relevant to have regard to a borrower's status as a group subsidiary, that a commercial lender perspective should be adopted in applying Division 13 and that in applying the arm's length test a borrower was not required by that Division to be regarded as a stand-alone entity.

Subsection 136AA(3)(d) provides:

(3) In this Division, unless the contrary intention appears:

(d) a reference to the arm's length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition;

However, it could be argued that the independent dealing benchmark being sought by the subsection 136AA(3)(d) definition is met in a case where a subsidiary deals with an independent lender on an arm's length basis in circumstances where that lender has secured a guarantee from the borrower's ultimate parent. The objective in the statutory language is to predicate on the basis of evidence of independent dealings the interest rate that would have been agreed by the subsidiary. It seems unrealistic to suggest that the rate would have been higher than the rate that could have been obtained by the group as a whole, especially where the group actually pursued a policy of ensuring external borrowing costs are kept to a minimum.

It is also true that subsection 136AD(3)(c) is focussed on the consideration that the taxpayer gave or agreed to give, and whether it is exceeds the arm's length consideration. But there is nothing in the subsection that precludes taking account of a taxpayer's status as a subsidiary and the further consideration that might reasonably be expected to be provided by the taxpayer's parent in the context of a loan from an independent lender in arm's length dealings - and that would have the effect that the taxpayer might reasonably be expected to pay less for the loan than it would on a stand-alone basis. This seems unexceptionable in the context of the way commercial lenders and debt markets deal with subsidiaries of multinational groups. It seems eminently sensible that CAHPL's status as a subsidiary of Chevron was relevant to the determination of the arm's length consideration for an AUD equivalent loan of USD2.5 billion "as an objective fact in the real world"[132]. His Honour's conclusions that it was necessary to have regard to CAHPL's subsidiary and industry status (paragraph 80) and that the concept of "independent parties dealing wholly independently with each other" does not require that the borrower as an independent party be considered as a stand-alone company (paragraph 79) provides a sound basis for this approach. As does the Chevron group policy of ensuring subsidiaries obtain the lowest cost of funds on their external borrowings, exemplified in the ultimate parent's guarantee of the wholesale debt funding raised by CFC. There may in some cases be a separate question, depending on the particular facts and circumstances, of whether a subsidiary ought to pay a guarantee fee to its parent, and, if so, how much.

On appeal[133] the Full Court took account of CAHPL's position as a subsidiary of Chevron and, in its assessment of what consideration CAHPL might reasonably be expected to pay to an independent lender, took account of the likelihood that security and operational covenants would have been provided to ensure that the borrowed funds could be raised at the lowest cost. There are, however, some subtleties in the judgments of Chief Justice Allsop and Pagone J that are worth exploring.

Chief Justice Allsop, who agreed with the reasons of Pagone J, added some further reasons ([2017] FCAFC 62):

> 3. In reaching a view about the meaning of these words and this phrase [property, consideration, might reasonably be expected to have been agreed or given] and how they operate in a coherent and cohesive way, it is paramount to recognise the fiscal and commercial context in which the provisions (and the provisions in Sub-div 815A of the 197 Act, to be discussed in due course) are operating. This is not to put to one side or diminish the necessity to begin and end with the words of the statute. Nor is it to seek to find a purpose outside the words. 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 Div 13.

[132] See *WR Carpenter Holdings Pty Ltd v Commissioner of Taxation* (2006) 234 ALR 451 at [20] per Lingren J, relied on by Middleton J in *SNF (Australia) Pty Ltd v FC of T* [2010] FCA 635.
[133] *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62

4. The fiscal and commercial context of Div 13 is the attempt to bring to tax in Australia, on a given hypothesis, income of a taxpayer whose affairs, but specifically the transaction in question, are, and is, international in character. 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 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. That is not to say that there was not commercial reality to the transaction as made within the framework that reflected a lack of independence between the parties, that is, within the relevant group or related company relationship.

5. 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.

6. 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.

15. A number of things are to be noted about ss136AA(3) and 136AD(3). First, for s136AD(3)(c), the consideration in the transaction in question (the international agreement in question) is given or agreed to be given **by the taxpayer**. Secondly, for s136AA(3)(d), the concept of the consideration that might reasonably be expected to have been given or agreed to be given had the agreement been reached between independent parties dealing at arm's length involves a suppressed premise or assumption that, in the real world, commercial parties could (and so would) enter into such a transaction such that an arm's length consideration can be hypothesised. Thirdly, there is no provision requiring the conclusion that any term of an international agreement must be either the "property" (or part thereof) or "consideration" (or part thereof). Fourthly, the process of identifying what is property and what is consideration, in any particular circumstances, may involve a process of characterisation governed by the definition of the terms, the commercial context and the requirement to hypothesise what might reasonably be expected to have been given or agreed to be given assuming independent parties.

16. ….the property the subject of the actual (s136AD(3)(c)) and hypothesised (s136AA(3)(d)) agreement does not change…..

19. The effect of interest payments made at the rate of 9% under the agreement created a tax deduction for CAHPL against its operating revenue from its interest, through its subsidiaries, in the North West Shelf gas project. The interest as income

> in the hands of CFC was not taxable in the United States…..Further, because CFC was a wholly owned foreign subsidiary of CAHPL, the dividends declared by CFC from the profits thus made were not assessable income in the hands of CAHPL: s23AJ of the 1936 Act. 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.
>
> 38. …financial or operational covenants by the borrower as to how it will conduct its business, how it will deal with its assets and, whether or not, or to what extent, it will in the future utilise its assets base to secure other lenders are commercial considerations one might expect in a loan made at arm's length if the lending were commercial: but which one would not necessarily expect in an intra-group borrowing where the lender is protected by common control of the affairs of the group, including those of the borrower. 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).
>
> 39. These aspects of the transaction in question, all being the lack of existence of promises to the lender or rights granted to the lender, are best analysed as part of the universe of what could possibly have been, or was given in return for the property in question, being the five year loan in the sum of AUD 2.5 billion. That is, they are best seen in the universe of the subject of consideration: that is had they been given, they would have formed part of it.

In relation to the application of the definition of "arm's length consideration" in subsection 136AA(3)(d) the Chief Justice's reasoning was as follows:

> 42. …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 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. There may be a free market into which disembodied independent third parties and the taxpayer alike could enter for substitutable or fungible goods; or there may be a market of sorts in which individually reached pricing will be available depending upon the precise characteristics of the party seeking to avail itself of the market. Given the great variety of commercial circumstances to which the provision may apply, it would be wrong either to approach the interpretation of the provisions pedantically or to dictate a rigid or fixed approach to the task of determining the arm's length commercial consideration.
>
> 43. There is no reason derived from the language of s136AA(3)(d) why the hypothetical based on independence should, of necessity, do other than assess what the taxpayer or a person in the position of the taxpayer would be expected to give by

way of consideration in respect of the acquisition of the property to a party independent from it. 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 t the consideration for the property. There is discussion in the Full Court in *SNF* 193 FCR at 179-181 [95]-[102] and in particular at [96]-[99] (the latter paragraphs being set out by the primary judge at [65] of his reasons) about the circumstances in which one can or should hypothesise the taxpayer as part of the exercise under s136AA(3)(d). The expression of the matter by the Full Court in *SNF* 193 FCR at 179-180 [96]-[99] must be read in the context of the argument of the Commissioner and the circumstances in the case…..

44. In *SNF*, the Commissioner's submissions were directed to the asserted inadmissibility of evidence of certain allegedly comparable transactions because the parties did not have the same features as the taxpayer, being a history of making losses. Some of the language in *SNF* may be seen to be broader than was necessary to deal with the arguments and controversy in question. I do not take from *SNF* any requirement for a rigid or fixed approach to the place of the circumstances of the taxpayer or the party posited in the position of the taxpayer, in particular here, its position in the group of which the other party to the actual transaction was a member also. Naturally, 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.

45. ….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.

46. Secondly, the primary judge said that the property should not be altered in the hypothesis. The terms of ss136AD and 136AA make that clear. That, however, is not to say that there must be no difference in the agreement as a whole. It will depend on how the property is identified – how it is characterised. Thus I do not consider [the view that Division 13 does not require or authorise the creation of an agreement with terms different from those of the actual agreement, other than the consideration] to be correct for all purposes. ….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.

60. ….First, the primary judge thought himself to be constrained by the Full Court in *SNF* not to give determinative effect to the CAHPL/Chevron relationship. For the reasons I have given, that takes the Full Court in *SNF* too far. 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. The evidence did not reveal any likelihood of Chevron charging a fee for such guarantee.

62. ….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.

63. For the hypothesis for the purposes of s136AA(3)(d) to include the parent company guarantee is not to alter the property the subject of an acquisition by the taxpayer. The task is to identify from the evidence the consideration that might reasonably be expected to have been given or agreed to be given by a party in the position of CAHPL (the taxpayer) in respect of obtaining a five year loan compared to the consideration actually given by the taxpayer. 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.

> 64. The property has not changed. As far as the borrower is concerned the loan remains repayable in five years. The consideration that might reasonably be expected to have been given or agreed to be given by an independent party in the position of CAHPL (the taxpayer) in these circumstances will be the interest rate charged by the lender for the borrowing taking into account the guarantee, not given by the taxpayer, but given by the parent in the position of Chevron.

Allsop CJ's approach of having regard to the statutory purpose of sections 136AD(3) and 136AA(3)(d), the wording of those provisions and the real world economic and business context of corporate financing in which they had to apply aligns quite closely with the systemic framework advocated in this paper. In his conclusion regarding the likelihood of a parental guarantee his Honour did not draw any distinction between cases where such a guarantee enables a borrowing by a subsidiary that would otherwise be impossible and the impact it has in cloaking the subsidiary with the AA credentials of the parent thereby allowing the subsidiary to borrow at the same cost as the parent could obtain. He did not see any deficiency in Division 13 in relation to the Commissioner's ability to rely on the borrowing subsidiary's connection to the multinational group and the policies the group employed in relation to external borrowings to ensure it minimised its borrowing costs. He saw these aspects as relevant to the hypothesis Division 13 required in relation to cross-border related party debt funding to Australian subsidiaries to ensure it was priced on an arm's length basis.

The other reasons for decision were delivered by Pagone J, with whom Perram J agreed. It is noteworthy that Perram J was a member of the Full Federal Court (with Ryan and Jessup JJ) that delivered a joint judgment in the appeal in the *SNF (Australia) Case* so one is led to the view that his concurrence with Pagone J suggests that the reasoning in *SNF (Australia)* and the *Chevron Case* are not in conflict when proper regard is had to the facts and circumstances of each case. It is important to note also that, although the Chief Justice provided elaboration as to his own reasons, he did not dissent from the reasons of Pagone J. and did not see a conflict between the Court's approaches in the *SNF (Australia)* and *Chevron Cases*[134].

The reasoning of Pagone J in relation to the operation of sections 136AD(3) and 136AA(3)(d) becomes evident from the following paragraphs of his judgment:

> 119 **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.** His Honour [Robertson J] correctly explained at [76] that this required the hypothetical agreement for acquisition to be depersonalised "so as to make it, hypothetically, between independent parties dealing at arm's length, but not so as to alter the property acquired". **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 basal assumption of transfer pricing provisions is that non-arm's length parties have selected a non-arm's length consideration for the acquisition of property which had a higher arm's length consideration [sic] than if the dealing had been between them as independent parties dealing at arm's length. That may proceed from a view of a paradigm case of transfer

[134] *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 at paragraphs 43-44.

pricing arrangements in which there are identifiable arm's length dealings for property of the type whose arm's length consideration is to be determined. **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 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]).

121 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 [sic] or acquisition in question. Accordingly, s136AD(3) may not apply to some non-arm's length supplies [sic] 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.**

125 ….CAHPL focused upon the words "independent parties dealing at arm's length" in the definition [of the arm's length consideration] as requiring a comparison between the actual agreement between the parties in question with a hypothetical agreement between other independent parties rather than a comparison between the actual agreement with what the parties might reasonably be expected to have given as consideration if their hypothetical agreement had not lacked independence and had been at arm's length. **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.**

126 ….. Section 136AD(3) requires, and depends upon, the ascertainment of an arm's length consideration. 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. In that regard it may be useful to note in passing that the nexus between the consideration and the acquisition is expressed by reference to the words "in respect of" rather than the word "for" and that the agreement in the hypothetical is described by reference to the indefinite article "an", indicating that the hypothetical in the comparison may be different from the actual agreement with which it is to be compared. 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 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.**

127 **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).

128 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. Thus, as his Honour held, the purchaser in this case need not be a hypothetical standalone company (see [79]) and was to be an oil and gas exploration and production subsidiary (see [80]). **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.

129 The policy assumption in the provisions to which the inquiry is directed is that the actual taxpayer in question would have given less consideration for what it obtained but for the lack of independence and the lack of arm's length dealing. 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. The purchaser (or in this case the borrower) may therefore, as his Honour considered at [79], be a company like CAHPL which is a member of a group, but where the consideration in respect of the acquisition identified in the hypothetical agreement is not distorted by the lack of independence between the parties or by a lack of arm's length dealings in relation to the acquisition.

130 **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].

131 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.**

132 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.** Ms Taherian accepted in cross-examination that the plan included that money would be raised at an interest rate that was close to US LIBOR and then lent to CAHPL at a higher rate of interest. Ms Taherian had been employed by CVX and its subsidiaries in the United States between 1996 and 2010 as director of international financing in the Treasury group although she had been a relatively junior employee from 2001 to 2005.

133 **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.**
>
> [Emphasis added.]

The following observations can be made regarding Pagone J's reasons. First, his Honour saw the arm's length test as articulated in subsections 136AD(3) and 136AA(3)(d) as operating on the basis that "there is something able to be compared" and he saw possible instances, like "a license to use certain intellectual property rights, internally generated know how or central management corporate services or finance", where this may not be the case and it may not be possible or practicable to determine the arm's length consideration. In his view the model on which subsection 136AD(3) is based presupposes that there exists a comparable agreement able to be compared with the actual agreement under which the consideration for the comparable agreement was not affected by the parties not being independent from each other and not having dealt with each other at arm's length in respect of the acquisition. He accepted *SNF (Australia)* as authority for the view that there is no requirement that the taxpayer necessarily be one of the parties to the hypothetical agreement. (Paragraphs 119 and 121).

Pagone J saw the application of s136AD(3) as requiring 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 (paragraph 121). His Honour saw 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" (paragraph 124). He thought that the taxpayer's argument that the pricing of a hypothetical loan was to be undertaken on the basis that CAHPL was a party to that loan with the attributes of the actual CAHPL but was otherwise independent was an unrealistic application of section 136AD(3) and contrary to its purpose (paragraph 125). Pagone J emphasised that 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 (paragraph 129) and he did not see that it would be a proper application of the provisions to embark on a pricing exercise based on the transaction as structured by the group and on the creditworthiness of the borrowing subsidiary whose capital structure had been determined by the group (paragraphs 131 and 132). In his view regarding CAHPL as if it

were an orphan and not a member of the Chevron group would distort the application of Division 13 and fundamentally undermine its purpose (paragraph 130). This analysis has important implications in terms of whether internal financing arrangements adopted by multinational groups are legally effective in reducing Australian tax. It is also readily apparent that these descriptions of the taxpayer's rationale, similar to the Full Federal Court's description of this rationale in the *SNF (Australia)* Case as "unsound", present major problems for it in terms of arguing it had adopted a reasonably arguable position for the purposes of the application of the penalty provisions in Subdivision 284-A of Schedule 1 of the *Taxation Administration Act 1953*. However, the Commissioner did not dispute that the taxpayer in the *Chevron Case* had a reasonably arguable position[135].

There has been much debate over the years amongst tax professionals as to whether Australia's transfer pricing rules permit a reconstruction of the agreement between the parties. This is sterile pursuit and the correct approach is to apply the machinery of the legislative provisions according to their terms, due regard being had to the statutory purpose. Pagone J saw the focus of the inquiry stipulated by subsections 136AD(3) and 136AA(3)(d) in determining the arm's length consideration as being an alternative agreement from the one actually entered into where the alternative agreement was made by the parties on the assumptions that they were independent of each other and dealing at arm's length, different from the actual agreement with which it is to be compared (paragraph 126) He saw the prediction contemplated by Division 13 as involving "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" (paragraph 127). His view was that the standard of reasonable expectation requires a consideration of the evidence to determine a reliably comparable agreement, which required the hypothetical to remain close to the actual loan (paragraph 128). He saw the property to be considered in the hypothetical agreement as being the same as in the actual agreement, namely a loan of US$2.5 billion for a term of years (paragraph 131).

Pagone J did not think that the findings of Robertson J – that at arm's length a borrower would have given security, and operational and financial covenants and that the interest rate as a consequence would have been lower - should be disturbed (paragraph 131). He felt that the evidence amply supported Robertson J's prediction of the reasonable expectation of a borrowing by CAHPL being supported by security and he made specific reference to the borrowing by CFC being supported by a guarantee from its ultimate American parent and the group's policy of obtaining the lowest cost of funding (paragraph 132). Without explicitly saying so, Pagone J seems to be alluding to the probability that Chevron would have provided a guarantee to ensure CAHPL could have borrowed at the lowest cost. His consideration of the alternative submission by CAHPL supports this conclusion. His Honour thought that the taxpayer's argument that the hypothetical acquisition would need to assume that CAHPL paid a fee to its parent for the provision of security "does have some force" (paragraph 133). In analysing the submission Pagone J focuses on the provision of parental guarantees, observing that CAHPL did not have the AA credit rating its parent enjoyed and "could not have borrowed US$2.5 billion on comparable terms to its parent without a guarantee supported by its parent".

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[135] Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092 at paragraphs 624 and 625.

In his Honour's view the consideration envisaged by subsections 136AD(3) and 136AA(3)(d) is not to be construed narrowly and was broad enough to encompass all consideration relevantly given in respect of the acquisition by the party receiving the property, 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. His Honour did not think that there was sufficient evidence to support a conclusion that a fee might reasonably have been expected to have been paid by CAHPL as part of the consideration in respect of the hypothetical loan. (Paragraph 133.)

It remains to be seen whether his Honour's observations have any impact in relation to tax planning strategies based on the use of parental guarantees and any fees that subsidiaries may be charged. However, these arrangements would have to comply with the arm's length principle as encapsulated in Division 13 and/or Division 815. One of the difficulties in the context of pricing intra-group financial guarantees is that the parent can dictate the capital structure and financial profile of its subsidiaries and hence manipulate the extent of the credit enhancement that a subsidiary obtains from a parental guarantee. While some multinationals may be tempted to re-litigate a variation of the stand-alone orphan subsidiary rationale, it is difficult to see how that might be framed to provide significant tax advantages given the Federal Court decisions that a subsidiary is not required to be regarded as independent from the group of which it is a member. See also the extensive discussion of parental guarantees in Chapter 5 and the earlier part of this Chapter. Pagone J concluded that "there was insufficient evidence on the case as conducted to warrant the conclusion that a fee might reasonably be expected to have been paid by CAHPL as part of the consideration that CAHPL might give in respect of the hypothetical loan" (paragraph 133). This leaves unanswered the question of whether CAHPL was creditworthy for a loan of USD2.5 billion, which conceptually would appear to be a prerequisite for obtaining a guarantee in respect of that loan from an independent party dealing at arm's length with the borrower and the lender, leaving aside any perception of information asymmetries in relation to financial risks that might dissuade a prospective guarantor from guaranteeing a subsidiary of a multinational in the absence of a parental guarantee. His Honour did, however, observe, that:

> 124. Much of the evidence of Mr Gross and Mr Martin 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…..

Harking back to the systemic framework being advocated in this paper, it is clear that Pagone J is paying due regard to the legislative policy intent and the commercial rationalism exhibited in dealings between independent parties dealing at arm's length in the real world market and business context in which Australia's transfer pricing provisions have to apply. His judgment, along with those of Chief Justice Allsop and Robertson J (at first instance), are likely to have significant impacts on the rationale used to justify global tax planning strategies that involve the setting of excessive interest rates on cross-border related party loans, both in terms of the calculation of appropriate interest rates under the arm's length test and in relation to whether the taxpayer's position is reasonably arguable for the purposes of the penalty provisions in Subdivision 284-A of Schedule 1 of the *Taxation Administration Act 1953*.

The application of Subdivision 815-A in the Chevron Case

It remains to consider how the Federal Court approached the application of Subdivision 815-A to address the overpricing of the loan from CFC to CAHPL. This was an alternative

ground to the application of Division 13 applying to only some of the years of income in dispute. Accordingly, on one view it was not strictly necessary for the Court to decide this issue but it made sense for Robertson J and the Full Federal Court to consider the issue given the importance of the legislative amendment and the possibility that the taxpayer might have appealed the decision on Division 13 at first instance and also sought special leave to appeal to the High Court.

The taxpayer's challenge to the constitutional validity of the Subdivision on the ground that in its retrospective application it imposed an arbitrary and incontestable exaction was unsuccessful.[136]

It is useful to first consider the legislative framework in so far as it was relevant to the facts and circumstances in the *Chevron Case*. In doing so it is also useful to consider the actual mechanism adopted by Subdivision 815-A in authorising the Commissioner to negate "transfer pricing benefits" obtained by an Australian taxpayer.

Section 815-10 provides:

> (1) The Commissioner may make a determination mentioned in subsection 815-30(1), in writing, for the purpose of negating a * transfer pricing benefit an entity gets.
>
> (2) However, this section only applies to an entity if:
>
> > (a) the entity gets the * transfer pricing benefit under subsection 815-15(1) at a time when an *international tax agreement containing an * associated enterprises article applies to the entity; or
> >
> > (b) the entity gets the transfer pricing benefit under subsection 815-15(2) at a time when an international tax agreement containing a * business profits article applies to the entity.

In so far as relevant to the facts and circumstances of the *Chevron Case* section 815-15 provides:

> (1) An entity gets a ***transfer pricing benefit*** if:
>
> > (a) the entity is an Australian resident; and
> >
> > (b) the requirements in the * associated enterprises article for the application of that article to the entity are met; and
> >
> > (c) an amount of profits which, but for the conditions mentioned in the article, might have been expected to accrue to the entity, has, by reason of those conditions, not so accrued; and
> >
> > (d) had that amount of profits so accrued to the entity:
> >
> > > (i) the amount of the taxable income of the entity for an income year would be *greater* than its actual amount; or
> > >
> > > (ii) the amount of a tax loss of the entity for an income year would be *less* than its actual amount; or

[136] [2015] FCA 1092 at paragraphs 528 to 553; [2017] FCAFC 62 at paragraphs 140 to 144.

(iii) the amount of a * net capital loss of the entity for an income year would be *less* than its actual amount.

The amount of the ***transfer pricing benefit*** is the difference between the amounts mentioned in subparagraph (d)(i), (ii) or (iii) (as the case requires).

…………..

(5) An ***associated enterprises article*** is:

(a) Article 9 of the United Kingdom convention (within the meaning of the *International Tax Agreements Act 1953*); or

(b) a corresponding provision of another * international tax agreement.

Article 9 of the *Convention between the Government of Australia and the Government of the United States of America For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (*the *"US Tax Convention")*, entitled Associated Enterprises, provides as follows:

(1) Where:

(a) an enterprise of one of the Contracting States participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the Contracting States and an enterprise of the other Contracting State,

and in either case conditions operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another, then any profits which, but for those conditions, might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

(2) Where profits on which an enterprise of one of the Contracting States has been charged to tax in that State are also included, by virtue of paragraph (1), in the profits of an enterprise of the other Contracting State and taxed accordingly, and the profits so included are profits which might have been expected to have accrued to that enterprise of the other State if the conditions operative between the enterprises had been those which might have been expected to have operated between independent enterprises dealing wholly independently with one another, then the first-mentioned State shall make an appropriate adjustment to the amount of tax charged on those profits in the first-mentioned State. In determining such an adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

(3) Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person, including

> determinations in cases where the information available to the competent authority of that State is inadequate to determine the income to be attributed to an enterprise, provided that, on the basis of the available information, the determination of that tax liability is consistent with the principles stated in this Article.

The question of whether Article 9 of the *US Tax Convention* and Article 9 of the United Kingdom convention were corresponding provisions became an issue between the parties. at first instance, but not on appeal. Robertson J held that:

> 565. …..“corresponding provision” does not focus on the detail but refers to another provision the gist of which is the same……, acknowledging that the meaning of “corresponding provision” depends on the context……(paragraph 565)
>
> 568 In my opinion, Article 9 is a provision of the United States convention corresponding to Art 9 of the United Kingdom convention. It is sufficient that Art 9 of the United Kingdom convention deals with “associated enterprises” as does Art 9 of the United States convention and that the gist of each Article is the same….

Section 815-20 contains an interpretative assistance rule and provides:

> (1) For the purpose of determining the effect this Subdivision has in relation to an entity:
>
> > (a) work out whether an entity gets a * transfer pricing benefit consistently with the documents covered by this section, to the extent the documents are relevant; and
> >
> > (b) interpret a provision of an * international tax agreement consistently with those documents, to the extent they are relevant.
>
> (2) The documents covered by this section are as follows:
>
> > (a) the Model Tax Convention on Income and on Capital, and its Commentaries, as adopted by the Council of the Organisation for Economic Cooperation and Development and last amended on 22 July 2010;
> >
> > (b) the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as approved by that Council and last amended on 22 July 2010;
> >
> > (c) a document, or part of a document, prescribed by the regulations for the purposes of this paragraph.

The interpretative assistance rule is modified in the *Chevron Case* because the amended assessments raised in reliance on subdivision 815-A, namely those for the 2006 to 2008 income years, pre-date the 22 July 2010 version of the OECD’s transfer pricing guidelines. In such a case section 815-5 of the *Income Tax (Transitional Provisions) Act 1997* provides that the guidelines as last amended before the start of the relevant income year are to be used. In the *Chevron Case* the relevant guidelines were the 1995 version.

Section 815-25 provides a special rule addressing the interaction of Australia’s transfer pricing and thin capitalisation regimes. It provides:

(1) This section modifies the * transfer pricing benefit an entity gets, or apart from this section would get, in an income year if:

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

(b) the transfer pricing benefit relates to profits, or a shortfall of profits, referable to costs that are * debt deductions of the entity for the income year.

(2) If working out what those costs might have been, or might be expected to be, involves applying a rate to a * debt interest:

(a) work out the rate by applying section 815-15, having regard to section 815-20; but

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

Note: Division 820 may apply to further reduce debt deductions.

Section 815-30 allows the Commissioner to make a determination regarding the negation of transfer pricing benefits. It requires the Commissioner to specify the component of taxable income to which the adjustment relates and the type of income, deduction, capital gain or loss affected by the adjustment, unless it is not possible or practicable to do so. This is important in cases like the *Chevron Case* where interest expense is adjusted in accordance with the transfer pricing rules because the interaction with the thin capitalisation rules would need to be understood.

Some observations can be made about the way that the arm's length test is framed in Subdivision 815-A relative to how it is framed in Division 13. First, the Subdivision operates in parallel with Division 13 but prevents the possibility of double jeopardy[137]. By using the mechanism of incorporating the Associated Enterprises Articles of Australia's double tax conventions[138], 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 dealings 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.

In his judgment at first instance ([2015] FCA 1092) Robertson J addressed the substantive operation of Subdivision 815-A to the facts and circumstances of the Chevron matter as follows:

[137] See section 815-40 of the *Income Tax Assessment Act 1997*.
[138] Subsections 815-10(2) and 815-15(1) and (5) of the *Income Tax Assessment Act 1997*.

582 …. the respondent submitted there were some eleven conditions which differed from those which might be expected to operate between independent enterprises dealing wholly independently with one another. These included: that CAHPL owned CFC and they both had a common parent, CVX; CVX Treasury decided how much debt and at what interest rate CAHPL should borrow from CFC; there was no bargaining or negotiation between CAHPL and CFC; the terms and conditions of the Credit Facility Agreement, including the terms in respect of the interest rate charged, the duration and the currency of the loan and the absence of covenants; the sole reason for CFC's incorporation, and the purpose of its commercial paper program, was to raise funds solely to on-lend to its parent CAHPL; that the credit profiles of CFC and CAHPL could be controlled by decisions made by CVX; that CFC profited from lending to CAHPL at a high interest rate; and the higher the interest-bearing loan from CFC and the higher the interest rate, the more profit CAHPL stood to make.

583 As to the currency of a loan, although it is not necessary to my conclusion, I am not persuaded that the condition as to the AUD currency which was operational between CAHPL and CFC differed from the condition as to currency which might have been expected to operate between independent enterprises dealing wholly independently with one another. I accept the applicant's submission in this respect that borrowings in AUD would avoid or limit foreign currency gains and losses. I am not persuaded Professor Boymal's opinion to the contrary.

………..

598 …….. It is necessary to start and finish with the words of Subdiv 815-A, both as to what they do provide and as to what they do not.

599 ………. the respondent submitted that the applicant would have the Court approach the arm's length pricing analysis by reference to the exact terms of the Credit Facility Agreement, which would not have been agreed between arm's length parties, as opposed to the terms that might be expected to have been agreed between CAHPL and CFC had they been independent of each other. The respondent submitted that the provisions in Subdiv 815-A (as in Art 9) required that there be an examination of the "conditions" operating between the two associated enterprises – not just the price – and an evaluation of profits absent the identified "conditions". That is, the respondent submitted, Subdiv 815-A did not envisage that one should take a related party loan transaction exactly as one found it and price the interest payable on the transaction (if that was even possible). Rather, by focusing on "conditions" as the matter that was to be hypothesised on the counterfactual analysis, Subdiv 815-A recognised that associated entities may have dealings which are non-arm's length for reasons apart from the price that is attributed to them. It followed, in the respondent's submission, that the applicant's contention that the Commissioner or Court may not depart from any of the actual terms of the Credit Facility Agreement, other than interest rate, found no basis in the express terms of the provisions of Subdiv 815-A.

600 **In my opinion, the applicant's submissions suffer from the use of a shorthand as to not "re-characterising" or not "rewriting" as a substitute for the statutory language and thereafter to describe what the respondent**

Commissioner has done as impermissible because it involved "re-characterisation" or "rewriting". On the other hand, the respondent's submissions seek to align Div 13 and Subdiv 815-A without sufficient regard to the different language of the two sets of provisions: Div 13 focuses on "consideration" whereas Subdiv 815-A focuses on the broader term "conditions". Having said that, I accept the respondent's submission that by focusing on "conditions", Subdiv 815-A recognised that associated entities may have dealings which are non-arm's length for reasons apart from the price that is attributed to them.

601 Another significant difference between the parties in construing the provisions was that the applicant submitted, under the heading "Implicit Support" that the terms of Art 9 meant that one must consider the conditions that one might expect to see between a lender and a borrower who are *independent*, and are dealing *wholly independently* with one another. In the applicant's submission, the relationship between the lender and the borrower must therefore be eliminated in order to undertake this task, and in a situation where the entities in question were sister companies, so too must the relationship between each of them and their common parent. If that latter relationship were permitted to subsist, then it could not be said that the lender and borrower were independent or were dealing independently. Their hypothetical dealing would be infected by the characteristics of each party, the borrower in particular, that were referable to ownership by the common parent.

602 The applicant submitted that a textual analysis of Art 9 supported the contention that the concept of "independent enterprises" was used in contradistinction to, and as the converse of, "associated enterprises". The OECD Guidelines provided that two enterprises were "independent" if they were not "associated enterprises". It followed therefore, in the applicant's submission, that all and any attributes that give rise to entities being "associated" within the meaning of Art 9 must be disregarded in determining the attributes of the independent parties. Within Art 9 there were two conditions that could result in parties being regarded as associated. The first was participation by one entity in the management, control or capital of the other. Negating this attribute required one to ignore the parent-subsidiary relationship that in fact existed between CAHPL and CFC. The second condition of association was the same persons participating in the management, control or capital of the two enterprises. Negating this attribute required one to ignore the ownership by CVX of each of CAHPL and CFC. The terms of Art 9 thus required one to hypothesise a stand-alone borrower and a stand-alone lender. There was no room for implicit parental support which of necessity derived from the common owner, CVX. This was further confirmed in the OECD Guidelines, which said that Art 9 required one to treat members of a multi-national group as if they were operating as separate entities rather than part of a single "unified business", and thus "*attention is focused on the nature of the dealings between those members*".

603 The respondent submitted that while the transfer pricing rules required the affiliation between the parties to the transaction to be ignored, there was no warrant for ignoring the affiliation between a party to the transaction in question and *other* members of the group of companies of which it formed a part. To do so, the respondent submitted, would be contrary to the natural language of the relevant provisions, their judicial interpretation and the object and purpose of the transfer

pricing rules. Each of the relevant provisions focused on the relationship between the parties to the relevant transaction.

604 **While I accept the applicant's submission that one must consider the conditions that one might expect to see between a lender and a borrower who are independent, and are dealing wholly independently with one another, which is the language of Art 9, it by no means follows that where, as here, the entities in question are sister companies, also to be eliminated is the relationship between each of them and their common parent on the basis that, otherwise, it could not be said that the lender and borrower were independent or were dealing independently. In my opinion, independent enterprises dealing wholly independently with one another may still be subsidiaries and may still have subsidiaries even if the enterprises are independent of each other. I therefore accept the respondent's submission insofar as he contended that there was no legislative warrant for ignoring affiliation between a hypothesised party to a transaction and other members of that party's group of companies. At the factual level, at [606] below, I have accepted the applicant's submission as to implied parental support.**

605 This conclusion means that the applicant's high-level contention about "implicit support' also fails. **"Implicit support" may be generally relevant when assessing a borrower's credit rating.** The high-level contention fails because it relies on the proposition that the relationship between CAHPL and CVX and the relationship between CFC and CVX, CVX being the common parent, must be eliminated from the analysis.

606 The applicant's submission that the existence and worth of "implicit support" is a matter of fact remains unaffected. **I accept the applicant's submission, that in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on pricing by a lender in the real world. This was the evidence of Mr Martin and Mr Gross and the conclusion of an article published in 2014 of which Mr Hollas was a joint author: "Intercompany Financial Transactions: Factors to Consider in Analysing the Impact of Implicit Parental Support".**

607 **As to the applicant's reliance on a differentiation between the language of "association" and "independence", it seems to me that that 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.**

608 A further broad submission put by the applicant was that Art 9 mandated a determination of the "profits" which might have been expected "but for those conditions" and thus proceeded to consider a hypothetical situation in which commercial or financial relations take place, but absent the operation of the identified conditions. By its terms, the applicant submitted, Art 9 did not permit the addition of new "conditions" but was, instead, an "annihilation" provision.

609 In my opinion, the correct approach is to identify the conditions mentioned in Art 9 and then ask if there was an amount of profits which, but for those conditions, might have been expected to accrue to the entity but which has, by reason of those

conditions, not so accrued: s 815-15(1)(c). As I have set out above at [27], **Art 9 involves a comparison between, here, conditions which operate between CAHPL and CFC in their commercial or financial relations and whether those conditions differ from those conditions which might be expected to operate between independent enterprises dealing wholly independently with one another. It seems to me a distraction, in that context, to speak about "annihilation" provisions: conceptually the comparison between the actual conditions and the conditions which might be expected to operate between independent enterprises dealing wholly independently with one another is straightforward although its application may not be. In my opinion, nothing is "annihilated" but I accept that what must be compared are conditions which operate.**

610 Once the approach I have outlined is borne in mind, in my view, the applicant's submission: "By its terms [Art 9] does not permit the addition of new 'conditions'" does not assist. It follows that **I do not accept the applicant's submission that "Article 9 negates non-arm's length conditions but does not supply any condition which is absent and leaves the commercial or financial relations (as opposed to its terms) exactly as it finds it". It follows that I reject the applicant's submission that the "requirements" of Art 9 permit only an adjustment to the price of a transaction (in this case an adjustment to the rate of interest) for the purpose of determining the quantum of profits which might have been expected to accrue, and they might justify, but go no further than, the elimination of other terms or conditions upon which CFC lent to CAHPL**. As I have said, in the present case Art 9 involves identifying conditions which operate between CAHPL and CFC in their commercial or financial relations and seeing where they differ from conditions which might be expected to operate between independent enterprises dealing wholly independently with one another.

611 It is necessary to return to the applicant's submission, referred to at [589] above, that viewed in its totality, it cannot also be said that there were any profits which did not accrue to CAHPL in its commercial or financial relations with CFC and thus the requirements of Art 9 were not satisfied. The applicant's submission was that CAHPL paid interest on the loan to CFC and received dividend income from CFC. The Commissioner ignored the dividend income CAHPL received in the years in dispute. It may be that the Commissioner overlooked the dividends received by CAHPL because he did not consider them to be "profits" of CAHPL for the purposes of Art 9. He may have read "profits" to mean "taxable income" because of s 3(2) of the *International Tax Agreements Act*, set out at [22] above.

612 The applicant submitted that the word "profits" where first appearing in Art 9 did not refer to taxable income, but profits in its more generic sense. The applicant submitted that this was supported by the history of Art 9. The reference to profits in this part of Art 9 was the same profit referred to in the old Art 5 of the 1933 Draft Convention for the Allocation of Business Income between States for the purposes of Taxation: it was a diverted profit which must be allocated to "one of the enterprises". It would make no sense, the applicant submitted, to read the word "profits" in that phrase as meaning taxable income, as the enterprise which may get allocated those profits may not be resident in Australia. The profits which might be expected to accrue as mentioned in Art 9 were therefore to be taken to refer to profits generally. Once this condition of Art 9 was satisfied, namely that there were profits which might

be expected to have accrued to one of the enterprises, the mechanism whereby such profits may be domestically taxed (i.e. included in the taxable income computation) followed in Art 9 with the concluding language of that Article: “may be included in the profits of that enterprise and taxed accordingly”. It followed that the profits of CAHPL included the dividends it had received from CFC for the purposes of the first condition in Art 9 relating to profits. In that respect, it could not be suggested that because of the conditions operating between CFC and CAHPL, “profits” did not accrue to CAHPL which should have. In other words, there had been no diversion of profits to CFC, and CAHPL’s expense, precisely because they had returned to CAHPL. The respondent Commissioner submitted that s 3(2) of the *International Tax Agreements Act* applied to the profits referred to in Art 9(1) and deemed them to be taxable income derived by CAHPL. Neither party referred to any authority on the point.

613 **In my opinion, s 3(2) of the *International Tax Agreements Act* has a limited purpose, as set out in the explanatory memorandum to the Income Tax (International Agreements) Bill 1953, circulated by the Treasurer, the Rt. Hon. Sir Arthur Fadden:**

> **The proposed sub-section (2.) is, subject to minor drafting variations, the same as the corresponding provision enacted in 1947 as sub-section (2.) of section 160F of the Assessment Act. Its purpose is to permit references in agreements to profits to be construed, unless the context requires otherwise, as references to taxable income. The provision is required because the Australian law imposes tax upon taxable income and not upon profits as such.**

I do not, therefore, regard s 3(2) as having a substantive or deeming operation. The applicant’s argument based on the former Art 5 seems to me to be unnecessary to reach this conclusion which involves construing the different language of the present Art 9. **It seems to me that the words “and taxed accordingly” are included in the text of Art 9(1) so as to make it clear what the relevant Contracting State may do. Section 815-15(1)(c) has effect accordingly. I am not, however, persuaded of the correctness of the applicant’s consequential argument that “profits” means that in the present case there can be a net profit position arising from the particular arrangements between the parties. What is being dealt with by Art 9 is profits which, but for the difference between the actual conditions operating and the conditions which might be expected to operate, have not accrued to, here, CAHPL. I therefore do not accept the applicant’s submission that there were no profits which accrued to CAHPL.**

614 Having rejected the applicant’s submissions, primarily submissions as to the proper construction of Art 9 and of Subdiv 815-A, and having considered at [505]-[524] above the evidence of the applicant’s main witnesses, I find that the requirements in the *associated enterprises article for the application of that article to CAHPL are met. I also accept the respondent’s submission identifying conditions, set out at [582] above. I find that but for the conditions operating between CAHPL and CFC which differ from those which might be expected to operate between independent parties dealing wholly independently with one another an amount of

> profits might be expected to have accrued but has not so accrued. It follows that the applicant has failed to show that the assessments under the ITAA 1997 were excessive. As I have said, my consideration of these matters is in the alternative to my conclusion as to the assessments made under Div 13 of the ITAA 1936.
>
> [Emphasis added.]

While Robertson J was not persuaded that the condition as to the selection of the AUD currency for the loan differed from the condition as to currency which might have been expected to operate between independent enterprises dealing wholly independently with one another, he did not see this as affecting his conclusion (paragraph 583).

His Honour did not see the application of Subdivision 815-A as limited to the pricing of a transaction on the terms and conditions established between the related parties and their parent; "[Subdivision] 815-A recognised that associated entities may have dealings which are non-arm's length for reasons apart from the price that is attributed to them" (paragraph 600). This approach by his Honour aligns with the reality of many global tax planning strategies to shift profits out of Australia; they can often contain structural as well as transactional elements. For example, the determination of the amount of debt to be carried by CAHPL is an integral part of the strategy to maximise the interest expense deductions in Australia and forms an important part of the rationale for the high rate of interest charged.

In relation to the concept of "independent parties dealing wholly independently with one another", Robertson J took the view, consistently with his approach to use of similar wording in Division 13, that Subdivision 815-A and the Associated Enterprises Article of the *US Tax Convention* did not require the elimination of the relationship between sister companies and their parent. In his view "independent enterprises dealing wholly independently with one another may still be subsidiaries and may still have subsidiaries even if the enterprises are independent of each other" (paragraph 604). In other words, the concept does not require the parties be stand-alone orphan entities, or as his Honour put it: "to say that a party is independent of another party does not mean or require that either party is independent of all parties" (paragraph 607).

This led his Honour to the conclusion that "implicit support" may be generally relevant when assessing a borrower's credit rating (paragraph 605) but on the facts and evidence before him he concluded "that in the absence of a legally binding parental guarantee, implicit credit support had very little, if any, impact on pricing by a lender in the real world" (paragraph 606). More fundamentally, this raises the question of what impact implicit credit support is likely to have on the decision by an independent commercial lender whether to lend the Australian dollar equivalent of USD2.5 billion and whether that would have also required a legally binding parental guarantee. In other words, in the real world it may not simply have been an issue regarding pricing. (See also the discussion above in relation to parental guarantees in the context of Pagone J's judgment on the Division 13 issue.)

In terms of the mechanics of Subdivision 815-A, Robertson J did not see the provisions as involving an "annihilation" of anything, but rather a comparison of the actual conditions with the conditions that would have been adopted by independent parties dealing wholly independently with one another in their commercial and financial relations (paragraphs 609-610). To the extent they were different and resulted in one or more transfer pricing benefits

section 815-10 authorised the Commissioner to make a determination to negate any such benefit.

On appeal Allsop CJ concluded Subdivision 815-A applied for the following reasons:

> 79 Section 815-15(1)(a) is satisfied – CAHPL is an Australian resident.
>
> 80 Section 815-15(1)(b) is satisfied – Chevron (an enterprise of the United States) participated directly or indirectly in the management or control of CAHPL (an enterprise of Australia).
>
> 81 Paragraph (c) of s 815-15(1) is central. It posits a causal relationship between the "conditions" referred to in Art 9 and "an amount of profits which … might have been expected to accrue to the entity" but which has not so accrued "by reason of those conditions".
>
> 82 **The notion of conditions in Art 9 refers to the circumstances or environment that can be seen to operate between the two enterprises in their commercial or financial relations which are different to the circumstances or environment which would operate between independent enterprises. The word "conditions" is broad and flexible.** The primary judge, at [582]-[583] of his reasons, referred to a number of individual conditions identified by the parties. Looking at the facts here one can, conformably with the way the respondent identified various conditions, see conditions operating between CAHPL and CFC which differ from conditions that might be expected to operate between CAHPL and an independent lender. **Those conditions included the direction of the affairs of both companies and their relationship in respect of the on-lending of the funds raised by CFC by Chevron Treasury, in particular, by Mr Krattebol, such direction being in accordance with the best interests of the Chevron group, and in particular to bring about the most efficient corporate capital structure and the best after tax result for the Chevron group.**
> [Emphasis added.]
>
> 83 **That condition or these conditions operated between CAHPL and CFC in their financial relations and was or were manifested in the Credit Facility.** The inquiry then for the purposes of s 815-15(1)(c) is what "amount of profits" might have been expected to accrue, but did not by reason of the conditions.
> [Emphasis added.]
>
> 84 The understanding of the nature of that causal inquiry is assisted by the discussion in the OECD 1995 Guidelines (the Guidelines). Paragraph 6 of the Preface to the Guidelines sets out the general approach:
>
> > In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their dealings with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate

> entity approach, OECD Member countries have adopted the arm's length principle, under which the effect of special conditions on the levels of profit should be eliminated.

85 The arm's length principle is set out in Art 9 of the OECD Model Tax Convention on Income and Capital.

86 The Guidelines discuss the arm's length principle in Ch 1. In the discussion of Art 9, the Guidelines state at [B.1.6]:

> By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.

87 The Guidelines in Section B, in dealing with the statement of the arm's length principle, discuss at [B.1.10] the practical difficulty in applying the arm's length principle that may arise from the fact that associated enterprises may engage in transactions that independent enterprises would not engage in. For instance, an independent entity may not be willing to sell or licence some valuable intellectual property or know-how. Some of the discussion is illuminating:

> [T]he owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, the intangible owner may be prepared to offer terms to associated enterprises that are less restrictive because the use of the intangible can be more closely monitored. There is no risk to the overall group's profit from a transaction of this kind between members of an MNE group. An independent enterprise in such circumstances might exploit the intangible itself or license it to another independent enterprise for a limited period of time (or possibly under an arrangement to adjust the royalty).

88 Section C of the Guidelines concerns guidance for applying the arm's length principle. The section begins (at [C.1.15]) with a discussion of comparability as follows:

> Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or

> margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. In determining the degree of comparability, including what adjustments are necessary to establish it, an understanding of how unrelated companies evaluate potential transactions is required. Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive.

89 The Guidelines in a section beginning at [C.1.36] discuss the recognition of the actual transaction undertaken. The whole of [C.1.36] – [C.1.38], though long, should be set out:

> A tax administration's examination of a controlled transaction **ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them**, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III. In other exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.
>
> **However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction**. The first circumstance arises where the economic substance of the transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in which an associated enterprise in the form of an interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital. **The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure**

> **practically impedes the tax administration from determining an appropriate transfer price.** An example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as previously indicated in paragraph 1.10). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in its entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.
> In both sets of circumstances described above, **the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.**
> [Emphasis added by the Chief Justice.]

90 The above discussion illuminates that **the causal test in s 815-15(1)(c) based on Art 9 is a flexible comparative analysis that gives weight, but not irredeemable inflexibility, to the form of the transaction actually entered between the associated enterprises. A degree of flexibility is required especially if the structure and detail of the transaction has been formulated by reference to the group relationship and a "tax-effective" outcome (even if, as here, one that is not said to be illegitimate). The form of that transaction may, to a degree, be altered if it is necessary to do so to permit the transaction to be analysed through the lens of mutually independent parties.**
[Emphasis added.]

91 There is nothing in the Guidelines that requires other than the independent status of the enterprises **from each other** in the transaction. Thus, to paraphrase the last sentence of [C.1.38], **Art 9 (and so s 815-15(1)(c)) would allow an adjustment of conditions to reflect the conditions which the parties would have attained had the transaction been structured in accordance with commercial reality with the parties to the transaction dealing at arm's length.**
[Second emphasis added.]

92 The conditions operating between CAHPL and CFC if they were independent of each other would not include the direction by Chevron Treasury of the officers of both for the benefit of the group as a whole. The conditions between mutually independent CFC and CAHPL could, however, include CAHPL situated within the Chevron group and CAHPL being subject to the direction of Chevron for the benefit of the Chevron group.

93 In such circumstances, **were CAHPL seeking to borrow for five years on an unsecured basis with no financial or operational covenants from an independent lender, in order to act rationally and commercially and conformably with the interests of the Chevron group to obtain external funding at the lowest possible cost consistently with any relevant operational considerations, it would do so with Chevron providing a parent company guarantee, if such were available.**

94 In the light of the evidence as to Chevron's policy concerning external funding and its willingness to provide a guarantee to achieve that end the above is the natural and commercially rational comparative analysis when one removes the controlled conditions operating between CAHPL and CFC and replaces them with the condition of mutual independence.

95 In the circumstances there would have been a borrowing cost conformable with Chevron's AA rating, which, on the evidence, would have been significantly below 9%.

96 One then must assess whether an amount of profits has not accrued thereby. The borrowing cost of CAHPL would have been less than it was under the Credit Facility; thus CAHPL's deductions against operating revenue would have been less, and operating profit conformably greater. There would, however, have been a reduced inflow of (non-assessable) dividends. **If one looks to the whole income year and compares the profits of CAHPL in the two scenarios one may not see a difference in amount of profits, although the two amounts would be differently formulated. In the actual transaction the profits are made up of lower (assessable) operating profit and higher (non-assessable) dividend income from CFC. In the hypothesised transaction the same level of profits are made up of higher (assessable) operating profit and lower (non-assessable) dividend income from CFC. There is, however, no mandate or requirement to look at the profit position of CAHPL only at year end. In point of fact, an amount of operating profit would have accrued with lower interest deductions; and turning to s 815-15(1)(d) had *that* amount of profits so accrued the amount of its taxable income would have been greater than its actual amount.**
[Emphasis added.]

97 The appellant must therefore have failed to show the assessments based on it to be excessive.

Pagone J, with whom Perram J agreed, concluded that Subdivision 815-A, in its substantive operation, applied to the facts and circumstances of the *Chevron Case* for the following reasons:

> 153 The interpretation to be given to Article 9(1) in its application in s 815-15(1)(b) must be in accordance with the rules of interpretation applicable to a treaty provision: see *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338. Article 9(1) was described in *SNF* at 109 as attempting "to address at a high level of generality the problems thrown up by transfer pricing by providing for pricing as if the transaction had been between independent parties". **The purpose of Article 9(1), as explained in *SNF*, and its function through the operation of s 815-15(1)(b), is to identify those conditions existing between enterprises in two countries affecting their financial or commercial relations. The identification of those conditions permits a broad and wide ranging inquiry into the relations existing between the enterprises concerned. There is not excluded from that inquiry the relationship existing between the parties such as parent or subsidiary. The factual inquiry of the conditions operating between the enterprises which needs to be undertaken is unconfined by the terms of Article 9(1), or by the terms of s 815-15(1)(b), by any circumstance other than that there be identified those conditions which bear relevantly and probatively upon whether they operate between the relevant enterprises "in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another". His Honour was, therefore, permitted to take into consideration, as conditions, the relations between CAHPL and CFC, and of other members of the Chevron group, notwithstanding that they were also identified as preconditions in (a) and (b) in Article 9(1)**………… In broad terms the structure of Article 9(1) may be seen in part to call for an inquiry into whether the circumstances in (a) and (b) give rise to the conditions "operating" which differ from those which might be expected to "operate" between independent parties. The relations existing between the enterprises are apt to be conditions that potentially operate upon the dealings between, and which bear upon, the inquiry into whether there are conditions operative of the kind contemplated. The matters identified by his Honour at [582] may fairly be said to be conditions which existed between CAHPL and CFC which operated between them which differed from those that might be expected to operate between independent parties dealing wholly independently with one another in respect of the loan.
>
> 154 The third condition in s 815-15(1)(c) was that an amount of profits had not accrued which might have been expected to accrue to CAHPL but for the conditions mentioned in the Article. His Honour found that this condition was satisfied; that is, that an amount of profits did not accrue to CAHPL that might have been expected to accrue to CAHPL but for the conditions mentioned in Article 9(1). At [614] his Honour said:
>
>> Having rejected the applicant's submissions, primarily submissions as to the proper construction of Art 9 and of Subdiv 815-A, and having considered at [505]-[524] above the evidence of the applicant's main witnesses, I find that the requirements in the *associated enterprises article for the application of that article to CAHPL are met. I also accept the respondent's submission identifying conditions, set out at

> [582] above. I find that but for the conditions operating between CAHPL and CFC which differ from those which might be expected to operate between independent parties dealing wholly independently with one another an amount of profits might be expected to have accrued but has not so accrued. It follows that the applicant has failed to show that the assessments under the ITAA 1997 were excessive. As I have said, my consideration of these matters is in the alternative to my conclusion as to the assessments made under Div 13 of the ITAA 1936.USD

CAHPL submitted that his Honour erred in this conclusion in part by reason of the construction of s 815-15 considered and rejected above. CAHPL also submitted, however, that his Honour erred in concluding that the profits requirement in s 815-15(1)(b) was satisfied by denying the necessity for a causative relationship between the conditions and the non-accrual of profits, and by not taking into account the fact that CAHPL received dividends from distributions made by CFC.

155 Section 815-15(1)(c) contemplated a relationship between the non-accrual of profits and the conditions mentioned in Article 9 by reference to a "but for" test. The determination of factual causation by reference to a "but for" test has been said to require the determination of whether something was "a necessary condition" of the "occurrence": see *Wallace v Kam* (2013) 250 CLR 375 at 383, [16]; *Strong v Woolworths Limited* (2012) 246 CLR 182 at 191, [20]; *March v E & MH Stramare Pty Ltd* (1991) 171 CLR 506 at 515-6. In this case the inquiry about the existence of such a causative relationship (in that sense) required an evaluative judgement about whether the conditions mentioned in Article 9(1) were necessary conditions for the non-accrual of profits which might have been expected to accrue. The function of the condition in s 815-15(1)(c) is to determine those profits which had been excluded from assessability and is the legislative equivalent of the words found in Article 9(1), namely, that profit "but for those conditions, might have been expected to accrue to one of the enterprises, but by reason of those conditions, have not so accrued". Article 9 goes on to provide that the contracting state, in this case Australia, may provide for the inclusion, and for taxation of the domestic enterprise, on those profits which had not accrued by reason of the conditions found to be operating between the enterprises that had differed from those that might be expected to operate between independent enterprises dealing wholly independently with one another.

156 **The evaluative judgment required by Article 9 required comparing the conditions which operated between CAHPL and CFC with those expected to operate between "independent enterprises" but that did not require his Honour to compare CAHPL and CFC with a wholly standalone company.** The purpose of the comparison is to determine whether profits have not accrued for tax in a jurisdiction which "might have been expected to accrue" but for the condition found to operate. His Honour was correct to reject CAHPL's contention that an "independent" company within Article 9 was a company which stood alone with no corporate affiliations…………

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. Ultimately the question was that of determining whether profits might have been expected to accrue to CAHPL if the transaction it entered into with CFC had been entered into where the conditions which operated between CAHPL and CFC did not operate, that is, where CAHPL and CFC had been dealing with each other wholly independently. The hypothetical thus required hypothesising circumstances in a dealing between an enterprise like CAHPL and an enterprise like CFC where, however, the conditions operating between them were between independent enterprises dealing wholly independently with each other. That is not to say that Division 815A, or Article 9(1), strikes down intracompany dealings which are not at arm’s length, because neither Division 815A nor Article 9(1) operates unless the relevant transaction causes (in the relevant sense) the non-accrual of an amount of profits in a contracting state in which it would have accrued if the transaction had been at arm’s length between independent parties. The fiscal policy which Division 815 and Article 9 express is not directed to intracompany non-arm’s length dealings but only to those intracompany non-arm’s length dealings which have a fiscal effect of reducing the tax that would otherwise have been expected to accrue in a contracting state. His Honour was correct to assume on the evidence that what might be expected to operate between independent enterprises dealing wholly independently with each other was a loan by CAHPL with security provided by its parent at a lower interest rate.

157 CAHPL next submitted that s 815-15(c) had not been satisfied because there was no amount of profits which had not accrued. In that regard CAHPL drew attention to the fact that it had received dividends from CFC albeit that they were non-assessable non-exempt income under s 23AJ of the 1936 Act. It was also submitted by CAHPL that the Commissioner may erroneously have considered the word profits in Article 9(1) to mean taxable income rather than to have been used in a more generic sense. Section 3(2) of the *International Tax Agreements Act 1953* (Cth) provides:

> For the purposes of this Act and the Assessment Act, a reference in an agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context so permits, as a reference to taxable income derived from that activity or business.

This provision applies also to the United States Convention but it does not result in the conclusion that the word “profits” appearing in s 815-15(1)(c) or in Article 9 is to be read so as to confine the inquiry required by s 815-15(1)(c) or Article 9.

158 His Honour was correct at [611]-[614] to reject CAHPL’s submission that there had been no profits which had not accrued within the meaning of s 815-15(1)(c) or Article 9(1). Section 815-15(1)(c) postulates that a consequence of the presence of the conditions in Article 9 was that “an amount of profits” which might have been expected to accrue did not accrue. **The word “profits” in the provision and in**

> **Article 9 is used in a more generic sense than "taxable income". The focus of the provision is the tax effect of a dealing not the overall income of a taxpayer. The specific focus in s 815-15(1)(c) is whether "an amount" of profits had not accrued, just as the focus of Article 9(1) is whether "any profits" had not accrued. There is no basis in the text of the provisions or in the policy they express to equate the profits referred to with the taxable income of the taxpayer.** The fact that CAHPL received dividend income may be relevant in evaluating what might be expected to accrue in the particular facts in question but it does not result in the conclusion that there was no amount of profits which did not accrue by reason of the conditions mentioned in Article 9 for the purposes of s 815-15(1)(c). The condition was satisfied by reason of an amount of profits not accruing but for the conditions mentioned in Article 9.

Looking to the future, it is worth observing that since the mechanics of Subdivision 815-B are framed in terms of a taxpayer obtaining a "transfer pricing benefit" as defined in section 815-120, the question of what is covered by the term "profit" remains an issue in cases in which a double tax treaty between Australia and another country operates. This is because the treaty delineates Australia's power to make a transfer pricing adjustment and is expressed in terms of a causal connection between non-arm's length conditions and any profits which, but for those conditions, might be expected to accrue but that did not so because of the operation of those non-arm's length conditions. Subsection 815-120(1) provides:

> (1) An entity gets a ***transfer pricing benefit*** from conditions that operate between the entity and another entity in connection with their commercial or financial relations if:
>
> > (a) those conditions (the ***actual conditions***) differ from the * arm's length conditions; and
> >
> > (b) the actual conditions satisfy the cross-border test in subsection (3) for the entity; and
> >
> > (c) had the arm's length conditions operated, instead of the actual conditions, one or more of the following would, apart from this Subdivision, apply:
> >
> > > (i) the amount of the entity's taxable income for an income year would be *greater* ;
> > >
> > > (ii) the amount of the entity's loss of a particular * sort for an income year would be *less* ;
> > >
> > > (iii) the amount of the entity's * tax offsets for an income year would be *less* ;
> > >
> > > (iv) an amount of * withholding tax payable in respect of interest or royalties by the entity would be *greater* .

However, despite the difference in mechanics between the Associated Enterprises Articles in Australia's treaties and Subdivision 815-B, there does not appear to be any inconsistency in the sense intended by subsection 4(2) of the *International Tax Agreements Act* 1953 that would cause the treaties to prevail over the subdivision and produce a different result in terms of the tax incidents comprising the transfer pricing benefits listed in subsection 815-20. In so far as the Associated Enterprises Articles are concerned the first two of the transfer pricing

benefits in subsection 815-120(1)(c) are relevant, namely that the entity's taxable income[139] for an income year would be greater, or the entity's loss would be less[140]. Each of these transfer pricing benefits is a consequence of an amount of profit, in a more generic sense, not accruing. Whether that is due to the fact that an amount of assessable income was not derived or due to the fact that allowable deductions were overstated (as was the issue in the *Chevron Case*) does not affect the precondition for the operation of the Associated Enterprises Articles but relates to the taxation mechanism that ensues once an amount of profit falling within the purview of those Articles has been identified.

In an overall sense, the decisions of the Federal Court in the *Chevron Case* suggest that it is possible under Australian tax law to challenge the legal effectiveness of structural as well as transactional elements of profit shifting strategies that some multinationals may be tempted to pursue. They also suggest that the Commissioner is not limited under Australian transfer pricing laws to simply pricing the transactions that have been constructed between related parties but may challenge whether the transfer pricing analysis being argued by a taxpayer proceeds from an arm's length footing or is in itself an artificial construct that distorts the application of the arm's length principle.

From a public policy perspective, it is vital that Australia's transfer pricing laws are effective in combatting the various manifestations of global profit shifting. The transactional drafting in Division 13 presents some possible limitations in that respect (which are discussed in Chapter 10 in relation to the *SNF (Australia) Case*). However, the drafting of Subdivisions 815-A and 815-B by reference to the broader context of commercial and financial relations and the operation of non-arm's length conditions more closely aligns with the systemic analysis framework being advocated in this paper in which structural as well as transactional elements need to be considered.

There is a deeper, strategic, significance that comes from the judicial considerations of the facts and circumstances and tax law issues in the *Chevron Case,* which is an international first in the area of transfer pricing and corporate finance. It is an important, and likely to be an enduring, example of how the Iceberg Model approach of understanding systems can be used in extremely complex contested situations to create the business narrative and the narrative of what the law is trying to achieve. It shows how the essential meaning can be created by understanding both those narratives. It reinforces the thesis of this paper that the company tax law needs to be seen in the context of the competitive market system in which it has to operate and the importance of understanding the human behavioural drivers of corporate behaviour.

[139] Section 4-15 of the *Income Tax Assessment Act 1997* sets out the general rule that taxable income for a year of income is calculated by adding up all components of assessable income and deducting from the total sum the amount of all allowable deductions.
[140] Section 36-10 provides that a tax loss for an income year is calculated by adding up all the deductions that can be claimed and subtracting the amount of the assessable income and exempt income.

Chapter 7: A multilateral approach to protect Australia's tax base

This Chapter examines the implications for policymakers, tax administrators and tax professionals of the increasing complexity of global economic value chains and the behavioural drivers and multi-dimensional methods used by multinational groups in their tax planning which were described in Chapter 3. Against that background there is an imperative for policymakers, tax administrators and tax professionals to consider tax issues on a unilateral, bilateral and multilateral basis, recognising that sometimes these different perspectives will overlap. The unilateral basis takes account of issues that arise purely in the domestic context in relation to the coherence and robustness of Australia's company tax regime. The bilateral basis encompasses the historical approach to international relations and the use of treaty shopping and cross-border arrangements between Australia and another country as tax planning devices. The multilateral basis takes account of the growing complexity of global economic value chains and the use in global tax planning of more complex structures involving the selection of favourable treaty and non-treaty countries, the use of tax havens, low tax jurisdictions and concessional regimes.

When one applies a systemic approach to the interaction of the tax systems of different countries, having due regard to the techniques of global tax planning available to exploit asymmetries between tax systems, it is clear that policy makers, tax administrators and tax professionals need to evaluate tax impacts on a multilateral as well as a bilateral and unilateral basis. The practical application of the internationally agreed arm's length principle seems to necessitate that the impacts on Australia of complex global tax planning structures be evaluated by reference to the role that the Australian operations play in the multinational group's global value chain in order to determine whether the incidence of taxation in Australia is aligned with the economic value (profit) that would have arisen if the Australian operations has been conducted on the basis of independent parties dealing wholly independently with one another.

The question posed by both the treaties and Division 815 is whether any conditions operated within the context of the commercial or financial relations that differed from those that would be adopted by independent parties dealing wholly independently with each other by reason of which profits did not accrue in Australia that would have accrued if the conditions were arm's length. Australia's role within a global value chain seems to fall clearly within the ambit of the "commercial or financial relations", which has been adopted as the frame of reference in the Associated Enterprises Articles in Australia's tax treaties and in Division 815. While the scope of the treaties is limited to commercial or financial relations between enterprises of the respective contracting States, and is bilateral in that sense, the scope of Division 815, while mirroring the mischief sought to be addressed by the treaties, is cast in broader terms than arrangements between treaty countries and seems capable of covering multilateral arrangements that create transfer pricing benefits. Subdivision 815-A does not have the common control test that forms part of the framework of the Associated Enterprises Articles of Australia's double tax conventions and therefore potentially applies to non-arm's length cross-border dealings between unrelated parties. Arguably a role allocated to an Australian subsidiary (for example as a marketer distributor) by a foreign based multinational group could also constitute an "international agreement" for the purposes of the former Division 13 and, subject to the facts and circumstances of a particular case, give rise to a question of whether the consideration for the performance of that role was an "arm's length consideration".

Leaving aside the question of whether particular tax avoidance strategies are effective in law, multinational groups may seek to use related party dealings across multiple jurisdictions (for example, by incorporating cashflow conduit or financial asset holding entities in tax havens or countries with tax concessional regimes) to shift profits to low or no tax jurisdictions. Techniques could include the creation of tax deductible streams like interest expenses that reduce the amount of taxable income in Australia. The interest income outflows could conceivably be channelled to countries that impose little or no tax on interest income derived from countries like Australia (for example countries that do not tax foreign source income). In cases where the home country exempts dividends from offshore direct investment, the funds flowing out of Australia as payments of interest might be indirectly channelled to the country in which the multinational is headquartered in the converted form of tax-free dividends. In cases where the multinational may not be able to repatriate the funds in a tax-free form, or may face high rates of tax on repatriation, it may choose to accumulate the interest income in the tax safe-haven country and lend the funds to the parts of the multinational group that need them, giving rise to interest expense deductions in that country and tax free interest income in the tax safe-haven country. Leaving aside the operation and proper administration of Australia's tax laws, including the transfer pricing rules and anti-avoidance provisions, multinationals may assert such strategies produce the result that little if any taxation is payable in any jurisdiction in respect of significant economic flows that have been generated in Australia.

The base erosion and profit shifting attempted by such conduit strategies may be exacerbated by section 25-90 of the *Income Tax Assessment Act 1997*. That section provides:

> An * Australian entity can deduct an amount of loss or outgoing from its assessable income for an income year if:
>
> > (a) the amount is incurred by the entity in deriving income from a foreign source; and
> >
> > (b) the income is * non-assessable non-exempt income under section 768-5, or section 23AI or 23AK of the *Income Tax Assessment Act 1936* ; and
> >
> > (c) the amount is a cost in relation to a * debt interest issued by the entity that is covered by paragraph (1)(a) of the definition of ***debt deduction***.

From a public policy perspective, it is difficult to see why the Australian tax base should be diminished through the deductibility of financing costs attributable to tax exempt offshore investment. While it may provide some benefit to Australian based multinationals that have to raise additional debt to fund direct investment offshore it is open to abuse by foreign based multinationals with major operations in Australia. Foreign entities can use Australia as a financing conduit for the investments they are making outside of Australia or loop their Australian entities in as part of funding arrangements for a restructuring of the group's global assets that does not otherwise affect its Australian operations. It is easy to see, for example, how a takeover in a third country or a scenario like that in the *Noza Holdings Case*[141] could be used to dump debt costs into Australia. Even where Australian based multinationals have to borrow to fund direct investment outside of Australia a large part of the financing cost can be attributed to the offshore investment, especially if that other country has thin capitalisation

[141] *FC of T v Noza Holdings Pty Ltd & Anor* [2012 FCAFC 43; 2012 ATC 20-313. The Illinois Tools group decided to restructure the holding of its intangibles, using a subsidiary in a low tax jurisdiction to buy them from group subsidiaries and license them back for a fee. The intangibles were routed through Australia as part of the restructure and the Australian entity was provided with debt funding for which it incurred interest expense to finance its participation in the restructuring arrangement.

concessions, so the allowance of the full borrowing costs in Australia gives the group a double deduction for some of the finance costs while the income from the investment is free of Australian tax in the hands of the Australian based multinational.

The application of Part IVA to global financing arrangements can be problematical since the group will probably be able to demonstrate the commercial need for the funding of real investment. Moreover, the operations and Australia's thin capitalisation provisions in Division 820 and the conduit financing concession in section 25-90 are intended to confer tax concessions and it would be difficult to invoke the general anti-avoidance provisions to deny those concessions.

The following observations can be made:

(a) it is neither feasible nor desirable to equate debt and equity funding in the context of economic and market analysis, nor in the context of tax policy formulation
(b) from the perspective of a multinational group, subject to any regulatory requirements, the extent of debt funding of Australian subsidiaries of foreign based multinationals is largely discretionary since most of the moderating influences in the open market system do not operate at the subsidiary level and there are significant tax (as well as other) biases in favour of maximising debt (see the discussion of the *Chevron Case* in Chapter 6)
(c) concessional thin capitalisation regimes tend to provide competitive advantages to foreign headquartered multinationals over Australian based multinationals
(d) subject to any tightening of thin capitalisation ratios, the repeal of the debt creation rules in Division 16F of the *Income Tax Assessment Act 1936* provides excessive tax advantages for foreign based multinationals in relation to Australian sourced income streams
(e) the tax and regulatory biases in favour of debt funding of economic activities in Australia or for using Australia as a conduit for financing economic activities in third countries have negative implications for Australia's tax base, national accounts and credit rating.

Australia's thin capitalisation regime and its interaction with the repeal of Division 16F, together with section 25-90 should be subjected to policy review.

Moreover, in terms of the application of Part IVA more generally, it seems odd that in a context where a multinational group may be using multilateral arrangements to avoid tax in Australia and other jurisdictions, the dominant purpose test in section 177D of the *Income Tax Assessment Act 1936* seems to allow the possibility that the avoidance of tax in another country can be seen as affecting the conclusion that the dominant purpose was to avoid Australian tax. This issue arose in *FC of T v News Australia Holdings Pty Ltd [2010] FCAFC 78; 2010 ATC 20*-191 where at paragraph 49 of the judgment the Court stated in relation to one aspect of the arrangement that was found to be "prompted by UK tax considerations:

> "Nor can it be said that this was an irrelevant consideration. Again, as News Australia submitted, both the fact of receiving advice and its content are able to be objectively determined. The advice received is relevant to the manner in which the scheme was entered into which is a relevant consideration under s.177D(b)(i)."

Since the intention of the dominant purpose test in section 177D is to protect the Australian tax base it defeats the public policy intent if multilateral tax avoidance can defeat its operation. The avoidance of another country's tax should not be relevant to the

determination of whether there is a dominant purpose to avoid Australian tax. Nor should compliance with a regulatory system of a low tax jurisdiction in relation to entities or transactions forming part of a global tax planning structure established by a multinational group.

The first of these issues, the weakness created by the need to give weight to the avoidance of another country's tax in determining whether there is a dominant purpose of obtaining a tax benefit in relation to Australian tax, has been recognised in amendments to Part IVA in relation cases where the taxpayer is a "significant global entity", which in essence is defined as a global parent entity or a member of a group that has a global parent entity and the group has annual global income for the period in question of $1 billion or more[142]. Section 177DA (schemes that limit a taxable presence in Australia) and sections 177H to 177R (the diverted profits tax)[143] each allow the cancellation of tax benefits in cases where it would be concluded on the basis of the statutory criteria that the person or one of the persons who entered into or carried out the scheme or any part of it did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:

(i) enabling a taxpayer to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of the relevant taxpayer's liabilities to tax under a foreign law, in connection with the scheme; or

(ii) enabling the relevant taxpayer and another taxpayer (or other taxpayers) each to obtain a tax benefit or both to obtain a tax benefit and to reduce one or more of their liabilities to tax under a foreign law, in connection with the scheme;

whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers.

The new provisions incidentally address the kind of issue that arose in the *News Australia Holdings Case* because the threshold of there needing to be a principal purpose of obtaining a tax benefit, as opposed to the need for a dominant purpose in section 177D, may be satisfied if the scheme is intended to secure a tax benefit in relation to Australian tax notwithstanding that the scheme also secures a reduction in liabilities of any person to tax under a foreign law.

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[142] Section 960-555 of the *Income Tax Assessment Act 1997*.

[143] Section 3 of the Diverted Profits Tax Act 2017 provides that tax payable in accordance with section 177P of the *Income Tax Assessment Act 1936* is imposed and section 4 provides that the rate of tax imposed is 40%.

Chapter 8: Data issues in assessing economic and tax system performance

A lot of work has been done internationally in relation to measuring and monitoring company tax base erosion and profit shifting (BEPS) as part of the OECD/G20 project on that topic. The final report on that work, entitled Measuring and Monitoring BEPS, Action 11: 2015 Final Report (accessible through the OECD website), contains a range of indicators of base erosion and profit shifting that countries may be able to examine on the basis of the data they presently have available. The report also discusses the data and analytical processes needed and makes a series of recommendations in the context of developing a global measure of BEPS

In the light of that work it would be expected that the ATO would be undertaking further research and analysis to see what can be learned about the Australian context from the OECD/G20 work.

This Chapter focusses on the Australian context and examines data integrity issues that can prevent systemic analysis or create endogeneity that masks what is really happening (in this case the “garbage in garbage out” effect in analytics produced by the use of data sets that are self-confirming because objective measures of profit needed to adjust anomalies are missing from the analysis). The aggregation of micro level data to form the overall picture of Australia’s economic performance, trends and projections raises the important question as to how micro level data can be tested for reliability.

Attempting to use available data sets to make the inherent connections between the macro and micro levels in the Australian economy raises questions about the sufficiency and reliability of the available data sets, and whether the purposes currently being served by the reporting are sufficient for sound economic management. A critical consideration in relation to the reliability of entity level reporting in Australia (including data on tax payments and provisions disclosed in statutory accounts) is whether the data reported is used to make investment decisions and evaluate the performance of the Australian operations. Where this is the case the data will have much higher relevance and reliability in terms of reflecting actual economic value creation. To the extent that this is not the case, the financial performance and profiles disclosed under Australia’s financial reporting requirements bear no necessary relationship to the economic value that has been created by operations in Australia by either Australian or foreign headquartered multinationals. For example, the financial statements of an Australian subsidiary of a foreign based multinational will understate its economic performance if it has engaged in profit shifting.

Similarly, if an Australian based multinational shifts profits into Australia because it needs to increase its tax payments so it can fully frank its dividends its financial statements will overstate the economic performance of the group’s Australian operations.

It follows that to the extent that the population of multinational groups operating in Australia engage in profit shifting their financial reports data will raise implications for the reporting of gross national product and gross national income data in Australia’s national accounts. In particular, where multinationals use debt financing as the means of shifting profits out of Australia, even where the debt levels are within the safe harbours permitted by Australia’s thin capitalisation rules, the aggregate effect and the associated interest charges will be reflected in the national accounts.

The reported accounting data on business performance becomes the starting point for the preparation of tax returns for entities that are Australian taxpayers[144]. The accounting data is then adjusted for variations between accounting calculations and tax law calculations (which can involve both reductions for tax concessions like accelerated depreciation and clawbacks for non-deductible items and statutory income items like provisions). The tax payable on the adjusted base amount is then adjusted for tax credits and offsets. The primary purposes of the tax return data are to report how the Australian taxpayer within the multinational group has calculated its Australian taxable income and the tax payable thereon on the basis of its own view of how the tax law applies. Other data in the tax return is collected for statistical purposes and as a basis for tax compliance risk assessment (for example, the schedule pertaining to international related party dealings). Needless to say, the potential distortion of the accounting data should a multinational have engaged in profit shifting is a matter to be considered in evaluating the reliability of the accounting data for both economic management and tax administration purposes. The potential for accounting data to obscure the actual tax paid by an entity subject to Australian company tax should also be noted. For example, the amount of company tax paid in respect of a particular tax year may vary markedly from the tax expense provided for in the financial statements for a group subsidiary operating in Australia.

However, because markets, rating agencies, multinational groups themselves and their shareholders pay close attention to the consolidated financial accounts and annual reports, multinational groups have a vested interest in accurately depicting the group's overall performance and profile at the consolidated level. Profit shifting is a case in point. The nature of profit shifting is that it does not affect the underlying revenue efficiency or cost efficiency of a multinational group as a whole other than through the reduction of taxation. Accordingly, the implementation of profit shifting strategies will be reflected in a multinational group's consolidated accounts; the profits will be included but the tax payments will be reduced.

There is an important distinction between tax reporting and business management reporting. Multinational groups have a vested interest in ensuring that their investment decisions are soundly based and that they have an accurate reflex of the economic and financial performance of all key aspects of their operations, including their product and service lines and their operations in each country. It is therefore important to understand the business recordkeeping systems and data of a multinational group, their planning, budgeting and reporting processes and the way they are used by group management to make and evaluate investments and how subsidiary and branch level results are consolidated into the overall group financial statements. Apart from what is reflected in the consolidated group financial statements and annual reports of publicly listed companies this management reporting data is generally not publicly available, but should be accessible to the multinational group's advisors, group management and tax administrators making enquiries.

Accounting consolidation highlights the important distinction between the group's dealings with external parties and employees in various countries and dealings between different

[144]Section 6 of the *Income Tax Assessment Act 1936* states that ***" taxpayer "*** means a person deriving income or deriving profits or gains of a capital nature. Division 6 of Part 1 of the *Income Tax Assessment Act 1997* sets out the core rules in relation to assessability in relation to residents and non-residents, including the concepts of assessable income, exempt income and derivation. Part 3-1 of the latter Act sets out the core rules in respect of capital gains and losses and the assessability of net capital gains.

members of the multinational group that "wash out" on consolidation. This has significant implications for group financing and the importance of distinguishing between external borrowings and intra-group debt funding, which can be much larger than the amount of external debt shown in the group's consolidated balance sheet. It also underlines more generally the importance of data that explains the nature and magnitude of cross-border related party dealings.

The quantitative data included in statutory reports and financial statements relating to an Australian subsidiary or branch of a foreign headquartered multinational, albeit presented in a way that aligns with the relevant accounting standards, is determined by specific statutory requirements, for example the need to show that the subsidiary or branch is solvent and has complied with any relevant regulatory requirements.

There are various ways in which a foreign headquartered multinational group can assure the solvency of its Australian subsidiary or branch without the need for a level of statutory equity that is sufficient for the risk weighting of its Australian operations and any unexpected contingency. For example, apart from a limited number of instances where capital adequacy or prudential safeguards apply, it is possible for a multinational group to seek to fund its Australian operations entirely with debt. It has options to provide guarantees or letters of comfort to the Australian management or Australian creditors that it will may the required payments in the event of a default by its Australian subsidiary or provide any funds needed to meet liabilities as and when they fall due for payment. It can defer or reschedule related party interest payments, convert related party debt to equity or inject additional equity from time to time to prevent an insolvency and provide a reasonable basis for local management to give the assurances that the Australian operations can meet their liabilities as and when they fall due for payment. Australia's thin capitalisation regime[145] does not mandate particular levels of statutory equity; it merely operates to deny "debt deductions"[146] that relate to the debt that is deemed by application of the statutory ratios to be excessive[147]. According to the tax law, a taxpayer can self-adjust its interest deductions in line with the thin capitalisation

[145]Division 820 of the *Income Tax Assessment Act 1997.*

[146]Subsection 820-40(1) provides:

> "***Debt deduction***, of an entity and for an income year is a cost incurred by the entity in relation to a * debt interest issued by the entity, to the extent to which:
>
> (a) the cost is:
>
> (i) interest, an amount in the nature of interest, or any other amount that is calculated by reference to the time value of money; or
>
> (ii) the difference between the * financial benefits received, or to be received, by the entity under the * scheme giving rise to the debt interest and the financial benefits provided, or to be provided, under that scheme; or
>
> (iii) any amount directly incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under the scheme giving rise to the debt interest; or
>
> (iv) any other expense incurred by the entity that is specified in the regulations made for the purposes of this subparagraph; and
>
> (b) the entity can, apart from this Division, deduct the cost from its assessable income for that year."

[147]For example, where an entity is not an authorised deposit-taking institution under the *Banking Act 1959,* subsection 820-185(1) disallows all or part of each debt deduction if an inward investing entity's average debt exceeds its maximum allowable debt. Section 820-220 sets out the formula for determining the amount of the debt deductions disallowed on the basis of the proportion of the excess debt to the average debt.

limits at the time of filing its tax return, without injecting any equity funding. It is arguably a matter for other areas of policy as to whether capital adequacy rules are appropriate.

It may be that in a given case the debt to equity ratio of an Australian subsidiary far exceeds the debt to equity ratio of the ultimate parent company of a foreign based multinational group. From an operational perspective the local management require sufficient CAPEX funding and budgetary allocations for their investments and operations; they are likely to be generally indifferent as to whether the required dollars are provided as debt or equity and, given the need for globally coordinated treasury controls, are unlikely to have any real authority to determine the capital structure of the Australian operations beyond the authority to formally execute the local aspects of the structures and documentation needed to implement group decisions. In many respects the multinational group is likely to regard its external debt and equity funding, retained earnings and cashflow as a fungible pool that can be classified and allocated in ways that best suit the channelling of intra-group flows and the minimisation of taxation impacts across its global value chain.

In order that tax policy settings for group financing align with the competitive market system the worldwide gearing of the multinational group would be the natural reference point. The combined pool of debt, equity, accumulated profits and group cashflows, together with the multinational's ability to optimise its productivity, profitability and market position, allowing it to raise further debt when needed at the lowest possible cost, comprise the funding drivers of the group's economic value chain. The ability to raise equity is also part of the equation. The level of equity carried at the consolidated group level is the funding that the group (or perhaps the market or the regulator) determines as sufficient to cover the business investment risk associated with all of its operations around the globe. Selecting the worldwide gearing of the multinational group as the reference point for thin capitalisation measures would ensure that the legislation is more robust against the classification and channelling options discussed in Chapter 3 that multinational groups have to structure intra-group funding and cashflows. It would better protect the corporate tax base, leaving tax rate adjustments as the mechanism to ensure Australia remains competitive as a destination for global (and domestic) capital.

Chapter 9: Data needed to identify tax risks and their tax system impacts

It follows from the foregoing analysis that in order to properly evaluate the performance of Australia's tax system it is necessary to identify and separately calibrate the impacts of:

(i) economic and business factors affecting the financial results and profiles of multinational groups operating in Australia;

(ii) the impacts of tax policy settings like the method for calibrating taxable profits, royalty and interest withholding taxes, tax expenditures, exemptions, concessions, credits, offsets and thin capitalisation limits on the amounts of taxes paid by those multinationals; and

(iii)any impacts of tax planning and tax avoidance in reducing tax payable by those multinationals and their effective tax rate.

It is not possible to fully understand the financial and taxation performance of a multinational group on the basis of a single year's data. Ideally, it would require a series of years that would be representative of the business and economic cycles and allow for wider economic impacts to be taken into account. Nevertheless, some aberrations in financial structure or profile may be evident even on a single year's data. Similar observations can be made in respect of the use of national accounts data and pattern and trend analysis. Published financial accounts data for companies operating in Australia, while relevant, is inadequate for this purpose. This has implications for national accounts data.

Developing a recursive model based on observed patterns and trends and economic stocks and flows at the macro and micro levels can assist in identifying the structural drivers and dynamics causing those patterns and trends or stocks and flows. It could also assist in developing more accurate measures for the responsiveness of real economic activity to tax policy settings. This would provide greater confidence as to whether revenue and broader economic and social objectives are reasonably capable of being achieved through tax policy settings, and that undue weight has not been given to any constituency.

The development of such a model would require significant investment. However, the relatively small number of multinational groups operating on a significant scale in Australia, the concentrations observed in the key sectors of the Australian economy and computer assisted collection and analysis of data suggest that such modelling is now feasible.

To realise its potential to assist the formulation of public policy settings the modelling would need to be supplemented by a methodology that would allow ***nominal*** patterns and trends and stocks and flows based on statutory and tax reporting to be refined to produce a more commercially realistic impression of the underlying economic performance of the group's operations in Australia. This refinement is needed to compensate for the fact that reported data may be affected by the impacts of any tax planning strategies used by multinationals. While the results of such modelling could never be precise they are likely to be more reliable that analysis based on unadjusted data.

One possible approach may be to make refinements to the data based on the "***real economic footprint***" in Australia and the likely financial contribution the activities make to the group's financial outcomes and profile having regard to the group's WACC and the rates of return available in the Australian economy. There are several useful economic integers in determining the "real economic footprint" a multinational group has in Australia. These

include assets, income (which can provide insight into market share), cashflow and operating expenditure (an indicator of the extent of activity). However, the values of these integers can be tainted by tax structures that distort the Australian section of the global value chain, related party dealings, misallocation of income and expenses across the global value chain, and back-to-back arrangements. Accordingly, only those integers for which there is reliable data can assist in determining a multinational's real economic footprint in Australia. (See also the discussion of data integrity issues in Chapter 8.) Public disclosures by multinational groups to explain their tax performance and management reporting may assist in this process.

It is the linking of macro and micro analysis and the patterning of that data having regard to that economic footprint that can produce strategically meaningful insights into the drivers of financial and taxation performance. Without that sensitivity, connectedness and ability to appropriately adjust the data the analysis is prone to endogeneity. For example, if data reported by multinationals that engaged in profit shifting is accepted on an unscrutinised or unadjusted basis, the reported profits will be net of any profit shifted out of Australia by those multinationals inclined to do so. If in such cases the reported profit is used as a basis for effective tax rate analysis the result will be unreliable because the economic profit has been understated and the effective tax rate is thereby inflated.

The selection of an appropriate benchmark profit indicator for a group's real economic footprint is challenging. Peer group analysis may give some indications of returns on investment, with Australian based publicly listed companies being a potential control group.

Where the multinational group is publicly listed on a reputable stock exchange some insights might be gleaned from a comparison of financial results reported in Australia and the consolidated financial reports of the ultimate holding company. For example, global gearing ratios and consolidated profit margins may provide insights as to whether the internal debt financing of the Australian operations (subject to any allowance provided by Australia's thin capitalisation rules) may be excessive relative to the business investment risks involved on the Australian side and the capital structure and credit rating of the group as a whole. While not determinative, it would also be possible to make a comparison of profit margins reported by Australian taxpayers within the multinational group relative to those enjoyed by the group as a whole. This might be particularly important in cases where structural losses are being reported on the Australian side. Moreover, the additional data required in Australian company tax returns for large companies (including the reporting of related party cross-border dealings) is likely to provide valuable insights. The Henry Review recommended that: "The Australian and the State governments should systematically collect data on aspects of existing taxes and transfers — including compliance cost data — according to consistent and transparent classifications and concepts, and make this information - including confidentialised tax unit records - freely available for further analysis and research". [148] This has been echoed by the OECD/G20 in relation to the furthering of their work on measuring and monitoring base erosion and profit shifting[149].

From a business investment perspective, the multinational group itself needs to know the economic contribution or losses being made by its Australian operations in order to properly oversight those operations and optimise group results and prospects. Internal management

[148] Recommendation 133, Chapter 12, *Australia's future tax system*.
[149] Chapter 4, Recommendation 6, Measuring and Monitoring BEPS, Action Item 11: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015.

reporting, adjustments made by the group in the course of consolidating its financial results, executive remuneration arrangements and capital expenditure proposals and evaluations are likely to provide insights into the real economic performance of the Australian operations, but are neither systematically collected outside the multinationals themselves nor publicly accessible. It therefore falls to the ATO to collect this information, sometimes through company tax returns and schedules and sometimes on a case by case basis when multinational groups are subject to ATO scrutiny, though even then this information may not be collected if the ATO adopts a narrow focus. There may be opportunities to systematically collect key financial integers like the multinational group's WACC, gross margin, effective tax rate and the pre and post-tax contributions to group profit from the group's Australian operations. Executive and other performance based payments made to Australian operatives can provide another line of sight.

An analysis of effective tax rates for each major multinational group at the consolidated level and in relation to its Australian subsidiaries may provide further broad impressions of tax system performance and the group's tax performance, though clearly these will neither be precise or conclusive. Bearing in mind the data integrity issues discussed above in relation to financial reporting by Australian subsidiaries of foreign based multinationals, a cluster of measures of effective tax rates that calibrated company tax paid relative to assets, income, expenditure and accounting profits and the monitoring of those trends in the indicators over time is likely to be more useful than a single measure. In an economic sense it would be expected that assets, income and expenditure (including in relation to suppliers, employees, trading stock, distribution and marketing) would all be drivers of profitability, though allowance would have to be made in any analysis for relative capital intensity. These factors also provide insights into economic productivity. Average indications of profitability and productivity are likely to be discernible from the consolidated financial reports of a multinational group, and these will be more reliable where the multinational is listed on a stock exchange or subject to regulatory control, but variances may be reflected the financial reporting of their Australian subsidiaries due to local factors or the impacts of tax minimisation strategies. Moreover, it would be expected that multinationals participating in service industries (for example, marketing wholesale distributors) would produce different financial (and hence tax) profiles from capital intensive industries like oil, gas, mining, manufacturing and construction.

Effective tax rates are impacted by major components of Australia's corporate tax system like accelerated depreciation, thin capitalisation, the limits applying to the taxation of capital gains and transfer pricing adjustments in relation to interest expense. In turn these tax rules are impacted by asset valuations, making tax asset valuations a strategic issue in the tax system.

It does appear that the valuation rules related to tax consolidation allow scope in some cases to increase valuations of assets attracting (or supporting claims for) tax concessions or forming the cost base for tax liabilities when a takeover or internal restructuring occurs. The economic and accounting rationale for the tax consolidation asset valuation uplift in these cases is unclear given the transactions involve a structural change in the ownership of an entity that is continuing to conduct the business with the same assets. The amount that an independent buyer will pay is influenced by the perceived value to the multinational group doing the acquisition, bearing in mind the investment criteria discussed above. It is the synergistic combination of a strategic acquisition within the existing global value chain of the multinational group and the possibility that value can be created by putting assets to a better

economic use or managing them better, together with perceptions that the share value of the target may be under-priced in the market, that influence the extent of any premium the group is prepared to pay. It does not follow that the Australian assets are necessarily worth more than their accounting or tax book values immediately before the acquisition, or that the base for calculating tax concessions should be refreshed. The change in ownership adds nothing to the remaining effective life of assets, or to their original cost, and the business has already obtained the benefits of tax depreciation on the basis of what it outlayed. Nor does it follow that the price paid by the new owners reflected a higher value for depreciable assets which was reflected in the acquisition price they paid to the vendor shareholders for the business. The reason for a price premium may be the perception of the untapped value of intangibles, immediate access to an established market share, full control of assets and income flows, opportunities for productivity gains and potential tax advantages associated with a capital restructuring of the acquired entity.

To the extent that the consolidation asset valuation rules in Division 705 of the *Income Tax Assessment Act 1997* allow a resetting of depreciable asset values for tax purposes, arguably they provide unwarranted increased tax shields for the existing cashflows from the existing businesses. The valuation rules are based on faulty reasoning and permit unwarranted tax concessions. These rules also undermine the operation of the capital gains regime by providing a tax shield for any taxable assets carried at less than their realisable value, should those undervalued assets subsequently be divested by the new owners. The ability to increase the gearing of an existing business on the basis of increased asset valuations also has the potential to impact the operation of the thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997* and reduce the tax paid by that existing business by allowing a greater level of debt deductions.

It follows that the policy basis of the valuation rules in Division 705 should be reviewed.

The amount of tax paid by a multinational group on its Australian operations can be the product of economic factors at the macro, micro and firm level. Typically, these factors may to some degree be influenced by the quality of business strategy and management, but are not controlled by the multinational group. Adverse global or local economic or market conditions can produce low levels of profit and in some cases losses. Where the low profitability and effective tax rate can be explained by reference to uncontrolled economic factors (bearing in mind the need to distinguish between group level outcomes and the economic contribution made by subsidiary companies) no issue arises for the performance of the tax system or its administration, unless the case demonstrates that there is a sound basis for tax system changes to promote better economic outcomes.

Where a multinational group has a significant economic footprint in Australia in an industry that is not experiencing adverse conditions and pays little or no tax, questions arise as to whether the tax performance is due to overly generous tax policy settings or tax avoidance. These two drivers of tax performance are not necessarily mutually exclusive since tax concessions may be exploited in some cases, for example by contriving the preconditions for the allowance of a concession in a case that was not envisaged by the policy, or where arrangements inflate the amount of a concession disproportionately to the underlying economics of the particular case. However, it may be possible to identify cases where a group is reporting reasonably good EBIT numbers, which would then raise the question of whether thin capitalisation rules and adjustments allowed in the calculation of the taxable income and tax payable are appropriate.

Regardless of industry, a multinational group with a significant economic footprint in Australia that had significant values of cross-border related-party dealings with low tax countries and very low or negative profitability is likely to invite scrutiny by practitioners or regulators concerned with tax compliance risk. Detailed factual and legal analysis would still be required to quantify any tax shortfall in a particular case and the causes of that shortfall.

Chapter 10: Transfer pricing issues related to marketing and distribution companies

The ATO's 2013-14 and 2014-14 Reports of Entity Tax Information show a significant number of companies operating in Australia that have significant amounts of income but are reporting no taxable income or tax payable[150]. The facts in *SNF (Australia) Case*[151] depict a situation where, despite good sales performance, the Australian entity carrying on business as a manufacturer, marketer and distributor in the mining, paper and sewage treatment industries and purchasing polyacrylamide products from offshore associates reported losses in each of the seven income years from 1998 to 2004. The structural loss picture created by the case appears commercially unrealistic. It raised important public policy issues about ensuring that entities given access to Australian markets are able to be effectively taxed on the contribution made by Australian operations through the functions performed, assets used and risks assumed, calculated by reference to arm's length rates of return.

The systemic analysis framework in Chapter 2 prompts questions as to whether the economic and financial analysis of the relevant global value chains and the commercial and financial relations between the parties comprising those value chains was somehow incomplete. It also prompts questions as to whether there is a particular tax planning typology that is producing the pattern of loss company cases within the large business population. To progress this analysis it is necessary to first consider the competitive market system in which marketing distribution companies operate and the role they play in the global economic value chains of multinational groups. It also requires a careful examination of the facts and circumstances of the *SNF (Australia) Case* (discussed below) to see if any tax planning mechanics can be discerned as a set of characteristics that can then be applied as search criteria to identify similar arrangements in the wider population of loss cases.

The competitive market system of marketing and distribution companies

Marketing and distribution companies are an important example of the potential breadth of corporate financing as a topic and of the financial relations and impacts that can be created between members of a multinational group in their commercial and financial relations. Applying the systemic analysis concepts outlined above it is possible to explore the competitive market system in which a marketing distributor has to operate it is possible to distinguish through a survey of arm's length comparables the economic contribution it makes to the group through the economic (value creating) functions it performs, the assets it uses (and creates) and the market, financial, operational and product risks it assumes (or has imposed on it). It is also possible to explore the sources of reward that the subsidiary has available to it and whether they produce returns that are commensurate with what independent parties dealing wholly independently with each other would agree as the level of compensation for its functions, assets and risks.

An evidence-based mapping of what happens at each stage in the group's economic value chain, understanding its business model, strategies, corporate policies, planning, budgeting and management processes, approval levels and delegations, its business management and evaluation processes and the nature and extent of the Australian subsidiary's dealings with

[150] The reports are available on the data.gov.au website.
[151] *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.

offshore associates allows a proper evaluation of the economic contribution made by the Australia operations. The relationships between the different stages of the economic value chain are critical to a proper understanding of each stage. For example, in an integrated manufacturing and distribution business model production levels would have to be determined by reference to estimates of customer demand, manufacturing production schedules and the group's market strategy. There will be inventory risks associated with each of these interdependent roles. Some risks will be associated with product design and obsolescence, some related to the quality of manufacturing, some to logistics and some related to just in time inventory management. There will be risks associated with marketing that may relate back to design risk, production quality and whether there is a reasonable match between levels of supply and demand for products and services. Independent parties dealing wholly independently with each other would be likely to allocate the various risks to the parties that can control them.

It is also important to understand the value proposition the group sees in the establishment and maintenance of an Australian subsidiary and how it monitors and evaluates that outcome, because this should drive the performance of the value chain, subject to factors that management cannot control.

In the context of commercial and financial relations between entities under common ownership and control it is likely that the rigour, formality and documentation common in dealings between independent parties dealing wholly independently with each other may not exist because it is not seen as necessary or cost efficient. Recognising these differences allows the identification and filling in of any blanks; undocumented arrangements that would never be allowed to be the subject of litigation between group members, but which are central to the allocation and proper coordination between the related parties of the economic functions comprising the global value chain. Contrasting the formal structure of any cross-border relations and transactions between members of the multinational group with evidence of the way the different parts of the economic value chain work in practice enables a consideration of whether the form is consistent with the economic substance. It also enables a judgment as to whether the financial impacts imposed on the various group members properly align with the economic roles of those members and allow an arm's length reward to be earned.

For example, a tied group marketing distributor in Australia will be required to purchase all of its trading stock from offshore associates at prescribed prices and terms of trade. The resulting gross margin may be insufficient to cover the operating costs, creating a structural loss position for the Australian subsidiary. Alternatively, the gross margin may be just sufficient for the subsidiary to make nominal amounts of profit, but less than the return an arm's length distributor would seek in comparable circumstances. Reported accounting and taxation losses on the Australian side do not necessarily mean that the group as a whole is losing money on its Australian operations. This could only be determined by a full profit channel analysis that established the full absorption and marginal costing of production, the economic costs associated with establishing and supplying the group's Australian subsidiary, meeting its genuine operating costs, third party sales revenues and the cashflows on the Australian side. However, under the arm's length principle, the net profit or loss outcome in the channel does not determine the Australian share. The arm's length principle requires that each stage of the economic value chain receives the level of reward that independent parties dealing at arm's length with each other would have agreed in comparable circumstances. Even if the economic value chain is in overall financial loss it does not follow that all parts of

the operations contributed to that loss; positive economic value created by one part of the value chain can have the effect of reducing the overall loss. The arm's length margin to be accorded to the Australian operations is not determined by what share the group can afford to, or is prepared to pay. (Compare the *SNF (Australia) Case* discussed below.)

Close coordination is needed between the production levels of the manufacturing entities, the marketing distributors' surveys of likely demand, the determination of how volumes of goods within the product range will be allocated across markets, delivery times, inventory turnover rates and the financial impacts at each stage of the value chain. This raises important questions of who should bear which risks. In some cases inventory management and market strategy will need to accommodate the sale of older and newer versions in the product range and the allocation of excess inventory. The group's management accounts, plans and performance reporting should contain the necessary information. However, it will be a market survey of arm's length dealings that provides the answers to the allocation of risks and rewards.

A marketing distribution subsidiary may be tasked by the group with developing a customer base at its own financial cost, unsupported by the multinational group, despite the advantages that other parts of the group derive from the increased sales and market share. The arrangement between the parties may not be the subject of an explicit agreement but reflected through the intra-group business planning and budgeting processes and the conduct of the parties. In pursuing its allotted role a new entrant in the Australian market is likely to incur relatively higher marketing and sales costs relative to incumbent competitor suppliers because it needs to actively solicit business. It is likely to have to offer discounts to attract potential customers to switch from their existing suppliers, or at least broaden their list of suppliers. This consequence is likely to be that the new entrant will appear less efficient relative to incumbent competitors, especially if its competitors have secured major long term supply agreements, unless rapid (or eventual) success by the new participant forces its competitors to respond. In either scenario it is likely there would be negotiation between independent parties dealing at arm's length with each other as to who should bear the costs of the market penetration strategy and what the likely level of remuneration would be for the marketing distributor entity. It would not simply be assumed that costs are attributable to the marketing distributor entity, which would be unlikely to agree to incur the financial costs associated with such a role without acceptable terms for its remuneration. Acceptable remuneration arrangements could be identified by market survey and may include an agreed net margin and mechanisms to support that margin relative to margins that downstream retailers may demand and in circumstances where the products or services being marketed and distributed do not receive the level of market acceptability required to underpin the agreed margin.

Where a new entrant pursuing a market penetration strategy is dealing in an imported physical product, or manufacturing products using imported parts or ingredients, it will need a reserve inventory from which to be able to readily and reliably supply new customers. It is likely in such cases that the new entrant will carry excess inventory relative to its competitors, especially local manufacturers, who are in a better position to match their production levels and inventories to customer demand on a just-in-time basis.

The new entrant will need its own trade credit and may need to be more flexible in granting trade credit in order to build market share or move excess inventory, leaving it more vulnerable to mismatching terms of trade between its suppliers and customers. The increased

customer credit risk may result in bad debts. An example of this in a different context was the relaxation of credit criteria by some of the foreign banks that entered the Australian corporate lending market in the 1980s, resulting in major write-offs like those related to the Bond Corporation.

Extra demands may be placed on an established marketing distributor if there is intense competition in the market or the competitive dynamics shift, for example where on participant launches a range of new products that give it a competitive edge. In such a case the remuneration of the marketing distributor would have to be reassessed on an arm's length basis, taking account of many of the factors discussed above in relation to new entrants.

In markets where the imported goods are faced with a range of competing brand products, a new entrant wholesale distributor will have to negotiate with retailers to obtain sufficient shelf space and promotion to achieve its turnover targets. These targets are likely to contain an element of striving over and above the product flows estimated as a result of the wholesaler subsidiary's local market analysis, particularly where the group is trying to increase its market share. All of these influences may require the wholesaler to supply retailers with products at discounted prices, squeezing the wholesaler's profitability, and potentially leaving the wholesaler undercompensated for its role and responsibilities absent further remuneration or reimbursement from its offshore associates. Suppliers able to sell to retailers or end customers at prices above their marginal cost of producing the additional volumes of product, are potentially able to move excess or obsolete global inventory into the new market. This would increase the capital efficiency of the producers and may enable the group to offset to some extent operating losses they might be experiencing in other jurisdictions.

Independent retailers will be seeking to maximise their margins and may seek margin support arrangements as part of any retailing agreement. In the event that customer preferences for competing products prevent the taxpayer from meeting planned sales volumes at the retail prices recommended by the overseas manufacturer, the retailers may seek approval to discount the products to increase turnover and to be compensated for any shortfall in agreed margins. The wholesaler subsidiary may suffer losses as a consequence if the group does not reimburse it for the compensation payments to the retailer. However, the weaker market response to product design, functionality, appearance and reliability are attributable to product design and manufacturing, which the wholesaler marketer cannot control. In an arm's length dealing the economic downside for these shortcomings is likely to be attributed to the design and production stages of the global value chain.

A local marketing distributor will also be the likely contact point for downstream retailers or end customers in relation to after sales service and repairs under product guarantees or warranties. These could cover: underperformance compared to advertised functionality; deficiencies in manufacturing quality or reliability; cases where the goods are deficient relative to advertised specifications; or, in some cases, where the goods are found to be dangerous or harmful. These problems can arise due to product design, testing faults or production problems. All of these are outside the remit and control of a marketing distributor, provided it has shown due care and diligence in its handling of the goods and did not itself engage in misleading conduct (a potential risk when global marketing material is required to be used by local marketing distributors). It would be unlikely that an arm's length distributor would assume financial responsibility for things it cannot control. It would be likely to seek arm's length compensation for any after sales service and repairs it provided.

The incidence of the types of financial, product and market risk in relation to marketing distributor operations outlined above all form part of the financial and commercial relations between the relevant parts of the multinational group. The allocation of these risks may be the subject of express arrangements between related parties. However, they may have to be evidenced from how the structures, transactions, business processes, and financial arrangements used by the multinational group impact on the marketing distributor. It is difficult to imagine that an independent marketing distributor would assume financial, market and product risks that it could not control and would not seem commercially rational to let them adversely impact the level of remuneration it receives for the functions it performs.

There may be a whole series of financial risks borne by the Australian marketing distributor. A proper analysis of the accounts and financial statement of that entity and a comparison with the margins made by independent marketing distributors will allow judgments to be made as to whether the entity has been appropriately remunerated for the role it performs in the multinational group's global value chain and the various financial risks it has borne. It may be that it is the aggregation of financial risks rather than any one particular risk results in under-compensation, or even a structural loss position. It is also possible that while each line of expenditure may be substantiated as being based on arm's length pricing, the misallocation of financial risks or a lack of arm's length compensation for the totality of the functions and risks may have the effect that the Australian profit is understated relative to arm's length outcomes.

Dr Charles Berry developed a ratio that can be used in relation to tied marketing and distribution companies to test their profitability based on the ratio of gross profit to operating expenses. These entities are strategically significant in the Australian context given the trend in imports and the income streams generated from the sale of imported goods to independent retailers or customers. In an arithmetical sense the Berry ratio indicates whether the gross profit margin is sufficient to cover operating expenses and allow an arm's length rate of return for the functions performed and the market and financial risks being assumed. It tends to be used where the quantification of income is reliable, for example where it comprises the proceeds from sales to independent customers[152]. Appropriate adjustments would have to be made for any retailer discount, market support, warranty and after sales costs borne by the distributor that are properly attributable to the design or manufacturing functions within the global value chain. The ratio assists the examination of whether the profit margin for the marketing distribution function is commercially realistic based on evidence of the margins made by comparable independent marketing distributors. Used in this way the ratio analysis provides an evidentiary metric of any profit understatement by a marketing distributor subsidiary in Australia, subject of course to the need to also consider how the financing arrangements for Australian entity impact on its profitability (see Chapter 6).

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[152] Berry ratio analysis was considered by the appeal court in *E.I. DuPont de Nemours & Co v United States 608 F 2d 445 (Ct Cl 1979)* in the context of determining the reasonableness of profit margins made by a Swiss marketing distributor where the prices charged to that company by the group for products were calculated to maximise the profits in a lower tax jurisdiction regardless of the value of the services the Swiss company provided, and ensure the Swiss company did not incur losses. The pooling of lowly or non-taxed profits was intended to fund further foreign investments by the group. In the circumstances the evidence led the court to conclude that there were no arm's length prices for the products and that other transfer pricing methods were appropriate to determine arm's length margins.

Where an Australian based multinational has a marketing distributor in a low tax foreign country or tax haven the Berry ratio analysis can assist the determination of whether the Australian suppliers are selling at prices that are so low that the marketing distributor makes excessive rates of return relative to arm's length margins.

Transfer pricing litigation involving marketing and distribution subsidiaries

Roche Products Pty Ltd v FC of T[153] is an example of a marketing distributor paying too much for prescription pharmaceutical products it was purchasing from offshore associates. The matter was heard by Downes J in his capacity as President of the Administrative Appeals Tribunal. Amended assessments had been raised on the alternative bases that Division 13 of the *Income Tax Assessment Act 1936* and the relevant Associated Enterprises Articles of the Swiss and Singaporean double tax agreements provided legislative authority for the adjustments. The matter was considered on the basis of Division 13 of the *Income Tax Assessment Act* 1936 rather than the treaties since, as Downes J explained at paragraphs 16 and 17 of his decision, despite the fact that the treaties referred to "profits" and not "acquisitions", and the difference in wording of the arm's length dealing test,

> "the parties spent little time dealing with the words of either set of provisions and effectively accepted that the same result would obtain whichever was applied."

At paragraph 191 of his decision Downes J stated

> "In the result I do not need to decide the issue although I note that there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between treaty parties rather than conferring any power to assess on the assessing body. On this basis Division 13 should be seen as the relevant legislative enactment pursuant to the power allocated."

Downes J stated at paragraphs 164 and 165 of his decision that,

> I do not think there is a rational basis for distinguishing between profit margins earned by Roche Australia for comparable and non-comparable drugs
>
> There is nothing in the evidence which suggests a different process was adopted in pricing the drugs. It is unlikely that one group is arm's length and the other not.
>
> Whether there were comparable or non-comparable drugs is largely a matter of accident. Using an arm's length price for one group of drugs to determine a profit margin for all other drugs when there is other useful evidence does not seem to me to be appropriate. I do accept, however, that the evidence does not permit the determination of prices for individual drugs and that it is necessary to take some overall view.
>
> When I take into account all these matters I conclude that an arm's length price for prescription pharmaceuticals would have yielded Roche Australia a gross profit margin of at least 40 percent throughout its range.

[153] [2008] AATA 639; 2008 ATC 10-036.

At paragraphs 172 to 174 of his decision he states in relation to the Consumer Products Division,

> 172. One starts with the proposition, perhaps irrelevant, that the gross profit margin for each drug (other than Aleve) is substantial. I say "perhaps irrelevant" because neither the parties nor the experts appear to deal with the gross margins in this aspect of the case. In a case in which ***the primary matter for concern is the cost of acquisition of goods and not profits*** (subject to considerations relating to the different tests in the double tax treaties and Division 3) this is surprising. I wonder whether there was enough "standing back and looking at the canvas in this case" or whether the case was too influenced by the ideas of US economists steeped in their traditions of transfer pricing issues rather than the application of Australian legislation…..[154]
>
> 173. ***The basic reason why the experts did not address comparable purchases was that none could be found. A second best method was chosen. However, I find it difficult to see that addressing gross profit margins was not at least relevant***, particularly as not much time was spent dealing with operating margins in connection with the Prescription Division.
>
> 174. The problem is compounded by the fact that ***a comparison of gross profit margins and EBIT to sales for each of the products shows that it was the operating expenses that caused potentially profitable operations to result in losses***…. [Emphasis added.]

He determined that the taxable incomes should be increased in respect of prescription pharmaceuticals, but rejected proposed adjustment to the Consumer Products Division, forming the view that the prices for consumer products charged to Australia were within the arm's length range.

The Commissioner did not impugn the operating expenses in the *Roche Case*. Both parties saw the contest as being about the pricing of the trading stock purchased by the Australian entity in relation to both the pharmaceuticals and the consumer products divisions. The facts presented to the tribunal as a result of the tax investigation and the tribunal's disclosure processes did not allow a full economic analysis of Roche's global value chains for the range of pharmaceuticals and consumer products imported by Roche Products to ascertain how much margin was being allocated to each stage of the global economic value chains and whether any value was being shifted to lower tax jurisdictions.

However, there are other cases where it is not the pricing of the trading stock purchased from offshore associates, nor the operating expenses as such that create the structural loss position. It is in these cases that the "Iceberg Model" and the reference to the competitive market system, supported by productivity analysis and economic functional analysis, provide a set of tools for understanding the economic drivers in the relationships between associated entities forming an economic value chain. They also provide a way of determining the most appropriate and reliable transfer pricing methodology to use, a requirement now explicitly specified in subsection 815-125(2) of the *Income Tax Assessment Act 1997*.

[154] At paragraph 33 of his decision Downes J notes that "none of the experts were either asked to, or did, directly address the provisions of either the double tax treaties or the Assessment Act".

In the *SNF (Australia) Case*[155] the ATO did not challenge the levels or types of operating expenses that the company incurred, relying solely on the argument that it was the overpricing of the products purchased from offshore associates that was the cause of the losses. This was no doubt driven by the ATO financial analysis which was tendered as part of their submission to the effect that over the relevant period for every $100 of sales it made, the taxpayer incurred selling costs of $28.57, and in those circumstances it paid $82.88 for the product it purchased from the related party suppliers, giving rise to a loss of $11.45 (paragraph 161(iv) of his Honour's judgment). 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, SNF (Australia) could not make any margin from its marketing and distribution activities across what was a growing market share (18% of the polyacrylamide market in Australia by 2002 according to paragraph 162 of the judgment). 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 continuing to burn equity. It received continuous and significant equity subscriptions and loans from SNF France (paragraph 162 of his Honour's reasons) as well as price support from the SNF group (paragraph 167 of his Honour's reasons). 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 ATO argued its case on the basis that the prices were higher than would have been agreed between independent parties dealing wholly independently with each other (paragraphs 160-165 of his Honour's reasons). Middleton J found that the reason for the losses incurred by SNF (Australia) was irrelevant (paragraph 157); 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.

A challenge faced by the ATO was that Division 13 of the *Income Tax Assessment Act 1936*, the precursor to Division 815 of the *Income Tax Assessment Act 1997*, was drafted in transactional terms that put the focus on price rather than profit. This is evident in the concepts of "[the acquisition of] property under an international agreement", "the taxpayer [giving or agreeing to give] consideration in respect of the acquisition and the amount of that consideration [exceeding] the arm's length consideration in respect of the acquisition" used in subsection 136AD(3).

[155] *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 difficult in seeking to frame non-arm's length structures and dealings producing commercially unrealistic ongoing losses within the machinery of Division 13 was alluded to by Middleton J in the following terms:

> 49…..I do not consider that the DTA's can be used to alter or impact upon the clear operation and wording of s136AD(3)……..
>
> 50…..the provisions do not just make that blanket prohibition [against the shifting of taxable income from Australia]. Section 136AD deals with one aspect – acquisition or supply other than at arm's length and arm's length consideration. In other words, the provisions deal with the situation where profits are shifted out of Australia, but only where that occurs through the technique or method of a person carrying on business in Australia purchasing products from an overseas affiliate at an inflated price.

The taxpayer was able to adduce sufficient evidence to demonstrate that it in fact paid the same or somewhat less than the prices the group had charged to independent distributors[156] and almost always paid less that the arm's length price determined by the free (global) market[157].

There was insufficient evidence of the channel profit, including no evidence in relation to how prices were set and the margins made by offshore associates[158]. The Commissioner's evidence did not provide evidence of the profits made by the independent comparable companies proposed by the ATO. In any event Middleton J saw the focus on profits as unnecessary in the light of the way the case was put by the parties[159], who were contesting whether SNF (Australia) paid an arm's length price for the products it purchased from offshore associates.

On the evidence available to him, and having regard to the way the ATO framed its case, arguably his Honour was not required to determine the cause of the losses reported by SNF (Australia). Nevertheless, at paragraph 166 of his judgment he made the finding that:

> the principal cause of the losses suffered by the taxpayer was to be found in an unreasonably low level of sales per salesperson employed by the taxpayer which resulted in a high level of commercial costs expressed as a percentage of sales. I also find that the other issues that contributed to the taxpayer's lack of profitability were competition in the Australian market, excessive stock levels, and poor management.

While this can be read as bolstering his Honour's conclusion that the pricing of the purchases from offshore associates was not the reason for the losses, it does not preclude the existence of other transfer pricing problems. This would require evidence that would support the articulate another form of transfer pricing problem that was able to be properly framed within the language and machinery of Division 13 of the *Income Tax Assessment Act 1936*.

It is clear from paragraphs 164 and 165 of the judgment that the ATO saw the relevant commercial and financial relations as being confined to the purchases of products from the offshore associates and that the transfer pricing problem was due to the fact that SNF

[156] [2010] FCA 635; 2010 ATC 20-190 at paragraph 69.
[157] [2010] FCA 635; 2010 ATC 20-190 at paragraph 149.
[158] [2010] FCA 635; 2010 ATC 20-190 at paragraphs 106-109, 134-5 and 147.
[159] [2010] FCA 635; 2010 ATC 20-190 at paragraph 148.

(Australia) was not free to negotiate its own prices but bore prices that were higher than those that would have been agreed between independent parties dealing at arm's length with each other. But is there more to the commercial and financial relations between SNF (Australia) and the offshore parent and members of the group than the purchase of product? Was the economic contribution of SNF (Australia) really economically worthless, as might be suggested by the outcome of the case? If so, why did SNF France see the Australian entity's role as strategic and continue to support it with continuous and significant equity subscriptions and loans and some level of price support? What was the value proposition for the parent company in having SNF (Australia) in place and continuing to operate? Would it be correct to say that the case did not present any transfer pricing issues?

The mapping of the global economic value chain, of which the Australian operations were a strategic part, enables a re-perception of the facts and circumstances in the *SNF (Australia) Case* within a broader economic frame of reference that reflects the economic substance of the group's business operations and the economic value contributed at each stage of the value chain. For the reasons set out below it is unlikely that in comparable circumstances an independent party would have been prepared to undertake the functions and financial risks on the terms and conditions under which SNF (Australia) operated.

The core economic functionality of SNF (Australia) can be deduced from evidence regarding the conduct of SNF (Australia)'s business operations and the market penetration strategy described in the judgment. It 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). While paragraph 3 of Middleton J's judgment includes a reference to SNF (Australia) carrying on a business of manufacturing, the case report has no details of any manufacturing activities being conducted by SNF (Australia).

It seems unlikely that the additional and increasing sales the SNF group was achieving in Australia would have been achieved without the functions performed by SNF (Australia). While the group could have used an independent wholesale distributor, as it had done in other instances[160], it appears that the group wanted a wholly owned and controlled subsidiary to develop a vertically integrated distribution and marketing channel covering the Australian market. This allowed the group to pursue its market penetration strategy in tightly controlled circumstances and harness the full channel profit to itself, this resulting in the formation of an Australian subsidiary (paragraph 2 of Middleton J's judgment). Prior to its entry the Australian market was being fully supplied by entities with whom, with certain exceptions, SNF (Australia) had to compete for market share. The exceptions relate to sales the SNF group was apparently making during the relevant period to Australian purchasers other than SNF (Australia) through its subsidiaries Chemtall Inc and Pearl River (paragraph 77 of Middleton J's judgment). Being a wholly owned subsidiary, the SNF group was able to control the pricing of supplies to SNF (Australia) and the allocation of the channel profit amongst the entities comprising its economic value chain that included its Australian product sales. On appeal to the Full Federal Court Ryan, Jessup and Perram JJ described this aspect in the following terms:

> The internal architecture of the group was such that the distributors purchased the chemicals from the [group] suppliers at prices which were determined by those

[160] There was evidence of sales to customers at the wholesale level of the market which the Court accepted as independent comparables to SNF (Australia).

> working at the helm of the group within SNF France. We may see at work, therefore, an exemplar of a modern multinational supply and distribution business: worldwide manufacture and distribution of useful goods; disparate corporate entities in multiple jurisdictions with different functions; the processes of commerce alive and well within the group but the negotiation function clipped by the overriding will of the ultimate parent.[161]

SNF (Australia) appears to have purchased products from associated offshore entities that were resident in France, the United States and China (paragraph 4 of the judgment), or from Eyang Chemical Co. Ltd. based in Korea, for distribution to customers in Australia. There was no evidence about the relationship between Eyang Chemical and the SNF group, but the purchases from Eyang do not appear to have been subject to transfer pricing adjustments (paragraph 7 of the judgment).

However, it is important to note that the SNF group was also able to control the capital structure of its Australian subsidiary. It is clear that SNF (Australia) was not established with sufficient equity to cover the financial and business risk associated with its entry into the Australian market. Its pattern of losses outstripped that capacity. It does not appear to be viable or creditworthy on a stand-alone basis. The financial profile and existence of related offshore party debt funding raise the possibility that there may be associated transfer pricing issues.

The group had a policy of supporting its subsidiaries (paragraph 167 of the judgment), which it did in the case of SNF (Australia) through continuous and significant equity subscriptions and loans from SNF France (paragraph 162 of his Honour's reasons) as well as price support by the SNF group (paragraph 167 of his Honour's reasons). This demonstrated the ongoing preparedness of the parent company to support its subsidiary. Purchases of trading stock appear on the basis of the Commissioner's submission to have remained by far SNF (Australia)'s largest expense item (paragraph 161(iv)).

The multinational group chose this approach to the establishment of its commercial and financial relations with SNF (Australia), relying on the financial strength of the SNF group as a whole, rather than establish a marketing and distribution arrangement that would have allowed SNF (Australia) to derive a margin sufficient for it to be economically and financially viable and derive an arm's length margin. This matter was not raised for determination with the Court, which was faced with a much more narrowly framed argument about arm's length pricing of purchases from offshore associates. Even if there were impediments to reducing the prices charged for the supply of products, perhaps Australia's anti-dumping rules or the need to maintain its global pricing strategy, the group still had other options discoverable by a market survey, like cost reimbursement, market support payments and wholesaler margins, to reward its Australian subsidiary at a level that an independent party was likely to have sought in comparable circumstances. The advantage of the financing strategy adopted by the SNF group was that it allowed SNF (Australia) to remain solvent to pursue the group's market penetration strategy primarily by supporting its balance sheet with equity and debt, but with some price support as well. This was much more tax efficient since profits ensuing from the derivation of an arm's length rate of return commensurate with SNF (Australia)'s functions, assets and risks would have been taxable in Australia.

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[161] [2011] FCAFC 74; 2011 ATC 20-265 at paragraph 1.

The limited financial information in the judgment does not lend itself to a full profitability analysis. This would reveal the relative efficiency of the inventory levels purchased by SNF (Australia) and the input costs it incurred as selling expenses, relative to the volumes of products sold and the sales revenues obtained. It would also reveal the patterns and trends in major items of income and expenditure and in SNF (Australia)'s profitability. However, with some important caveats about the need to do a year by year analysis, it is worth considering the general picture painted by the Commissioner's submission that over the relevant period for every $100 of sales it made, the taxpayer incurred selling costs of $28.57, and in those circumstances it paid $82.88 for the product it purchased from the related party suppliers, giving rise to a loss of $11.45 (paragraph 161(iv) of his Honour's judgment). It would need to be demonstrated by reference to evidence of comparable circumstances involving independent parties dealing wholly independently with each other that the arrangements between the SNF group and SNF (Australia) were not arm's length and that as a consequence SNF (Australia) did not receive an arm's length consideration for its functions. It seems improbable that there was sufficient scope for productivity improvements in relation to the selling costs to produce a commercial rate of return. The company was pursuing the market penetration strategy and this had implications for ongoing selling costs and the possible need to discount its selling prices to win customers from incumbent suppliers. The purchase prices for products are unassailable, having been proved to be at or slightly less than arm's length prices.

The means by which SNF (Australia) pursued its mandated market strategy are not revealed. The evidence, including the duration of the strategy and the progress in building market share, suggest that the SNF group was aiming to be the market leader in Australia. Its low sales per salesperson over a seven-year period allow the speculation that SNF (Australia) may have needed a larger sales force than the incumbent suppliers and/or may have had to sell its products at a discount, especially in the context of the competitive market referred to by Middleton J at paragraph 166 of his judgment. One would expect that the pricing used in the Australian market would be sensitive to the risk that extreme price competition might destroy any profitability in the market. There is no evidence as to whether the SNF group was considering strategic acquisitions as a means of increasing its market share; the facts and circumstances of the case suggest a path of organic growth was being pursued; but SNF (Australia) had achieved a significant market share and the changing competitive dynamics might cause some participants to become vulnerable.

Given that SNF (Australia) was distributing a physical product and seeking to progressively build significant market share over quite a few years one could speculate that it was likely that it would have required an ongoing level of reserve inventory to provide timely and reliable supply to any new customers, over and above the inventory levels of its local competitors who may have been able to better match their production levels to their customer demand. It is unclear how purchase volumes were determined though the parent company's desire to continue to expand its market share raises the possibility that the volumes supplied were tailored to the parent's objectives.

One might also speculate that SNF (Australia) may have needed to take more risk in providing trade credit in the hope of winning new customers, with the attendant risk of bad debts.

A number of the aspects attributed as causes of SNF (Australia)'s losses could arguably have been incidents of the market penetration strategy being orchestrated by the parent company,

notwithstanding there may have been some level of productivity gains that may also have been able to be harnessed under better management. It is a matter for judgment, based on evidence of the productivity of independent marketing distributors dealing wholly independently with their suppliers, and having regard to the strategic and operational drivers and materiality of SNF (Australia)'s selling costs, what the potential was for SNF (Australia) to realise productivity gains of an order sufficient to make it profitable. The relative scale of its selling costs to the magnitude of its losses suggests this would be an enormous challenge given the ongoing pursuit of a market penetration strategy.

The analysis of the patterns in the various lines of expenditure and what is driving them suggests that there is a financial ingredient that is missing from SNF (Australia)'s remuneration arrangements.

While all of the foregoing analysis of the real-world circumstances of SNF (Australia) is speculation, the scenarios are distinct possibilities within the competitive market system in which marketing distributors have to operate, but were not the subject of evidence or argument in the *SNF Case*. They are aspects worthy of investigation and the gathering of the evidence necessary for the operation of Division 13 and/or Subdivisions 815-A or B should similar cases arise in the sub-demographic of large company cases covered in the ATO's 2013-14 and 2014-14 Reports of Entity Tax Information – or indeed foreign owned subsidiaries in the Middle Market - that reported no taxable income or tax payable.

It remains to consider the allocation of profits and losses across the various stages of the SNF group's global value chain relative to the economic value created at each stage, the necessary focus in the present context being whether the economic contribution made by the Australian operations was rewarded on an arm's length basis. This issue would need to be framed either within the concepts of Division 13 as whether an "arm's length consideration" was given for the marketing and distribution services which SNF (Australia) supplied to the SNF group parent company and/or the associated offshore party suppliers under an "international agreement" (bearing in mind the broad definition of "agreement"). The intra-group financing might raise questions about whether any interest charges were arm's length. For the purposes of Subdivision 815-A or B as appropriate, there may be a question as to whether conditions "operated" or "existed" in or "in relation to the commercial or financial relations", that included the marketing and distribution services and the intra-group financing arrangements, that "differ from those which might be expected (to operate) between independent entities dealing wholly independently with one another in comparable circumstances".

Ideally, using the "Iceberg Model" and economic value chain analysis one would be able to understand the economic value being created at each stage of the value chain and determine whether the reported incomes and profits and the incidence of company taxation were properly aligned with the countries performing economically valuable activities, that financial risks were properly allocated and rewarded on an arm's length basis. While there is evidence referred to at [2010] FCA 635; 2010 ATC 20-190 at paragraph 141 that the related party suppliers "were … losing money on their sales to the taxpayer" it is not clear whether this is a reference to the opportunity cost they incurred in comparison to the prices they could obtain from sales to independent parties or (given the evidentiary gaps in the profit channel analysis referred to by his Honour) whether they were still able to make a margin on those sales. Notwithstanding that he was not prepared to accept the figures given in oral testimony by Mr Pich, the majority shareholder of the ultimate parent company, Middleton J accepted that SNF France had made losses over the relevant period but this was a matter that his Honour

regarded as irrelevant to the main task (paragraph 135). Even if it were the case that the SNF group's parent company and its suppliers were incurring economic losses, this does not address the issues raised by Division 13, Subdivision 815-A and Subdivision 815-B in their specific applications of the arm's length principle. The activities of SNF (Australia) could arguably have been creating economic value for the group by its sales and growing market share, thereby reducing the losses the group would otherwise have incurred. The sales could not have been realised without the role performed by SNF (Australia), the bulk of which appears to have been absorbed by the costs of its trading stock. Both the various requirements of the iterations of Australia's transfer pricing rules and the competitive market system require a recognition of SNF (Australia)'s economic contribution. This has to be determined by reference to the hypothesis of independent parties dealing at arm's length with each other in comparable circumstances.

The foregoing analysis demonstrates that the application of the "Iceberg Model" and an analysis of Australia's role within the global economic value chain, supported by economic functional analysis and productivity analysis, should give the assurance that all material transfer pricing problems have been correctly identified, in terms of both their structural characteristics and their transactional features. Only then can the most appropriate and reliable transfer pricing methodology be determined and the right public policy outcome achieved; namely that Australia's share of company tax is aligned with the economic contribution made by the Australian operations.

The *SNF (Australia) Case* is strategically important to a proper understanding of how tax law needs to align with the competitive market system in which it has to operate. It underscores, like the *Chevron Case*, the importance of being able to construct the business narrative, the real world of the taxpayer. Again, like the *Chevron Case,* it shows the importance of accurately constructing the narrative of what the legislation is trying to achieve. It exemplifies that sound jurisprudence will not allow an inadequate narrative, reflected in the narrow scope of the legislative drafting, to be stretched to achieve the desired tax policy objective. The key lesson is in how the case underscores the importance of taking a systemic approach to defining the tax policy issue in a way that is properly scoped; in this case the need to effectively address the undermining of Australia's company tax base through global profit shifting by making sure that the law addresses the underlying structural dynamics used on profit shifting arrangements, not just the symptom of the mispricing of intra-group supplies and acquisitions of property and services. It shows how the tax law needs to be framed in a way that it adequately covers the various manifestations of the tax policy issue needing to be addressed, due regard being had to the need to ensure that the articulation of that policy is aligned with the competitive market system in which it has to operate and is based on the commercially rational behaviour of independent parties dealing at arm's length in that market.

The *SNF (Australia) Case* was the catalyst that caused the strategic rethink of Australia's transfer pricing rules, leading to the enactment of Subdivision 815-A and then the broader framework of subdivisions 815-B, C and D. It is likely to have an international significance as other countries think about the robustness of their transfer pricing legislation.

Chapter 11 The critical role of the ATO in optimising the company tax base

A burning question in the minds of the Australian community is whether Australia is vulnerable or is getting its fair share of revenue from the profits that multinationals earn here. This is being echoed by the Government with the refrain that if it is earned here, it should be taxed here. This does not seem to be a party-political issue; the Opposition and the minor parties seem to be singing from the same songsheet. And while multinational groups are important to the Australian economy, their interests do not always converge with those of the general community. And while they are influential, their power is indirect, unlike the voting power of the general community.

Because of this vested interest in corporate citizenship the ATO has a critical role from an administrative perspective in ensuring that Australia is not fair game and does in fact get its fair share of tax based on the economic value that is created here from the activities of multinational groups.

This Chapter uses the systemic analysis framework described in Chapter 2 to evaluate the ATO's administration of the various activities it is conducting in relation to base erosion and profit shifting. The purpose is to draw various strands together into a high level strategic framework in the hope that it will increase the ATO's effectiveness in fulfilling its statutory mandate. This Chapter also analyses the publication on 11 October 2017 by the ATO of Tax and Corporate Australia (hereinafter referred to as "the ATO publication").

The ATO has the unique vantage point of being able to see the company tax system in operation across the entire population of the 1,400 major economic groups with a turnover of more than $250 million in Australia[162]. This comes with a corresponding set of responsibilities, some of which were discussed in Chapter 3.

The ATO's strategic role and what it means for how it administers

In a strategic and practical sense it can be argued that, primarily, as with other heads of revenue and taxpayer demographics, the role of the ATO as the relevant statutory revenue authority is to optimise the company tax base as defined by the law, and to make recommendations for areas of improvement. This necessarily involves deploying its resources to best effect. It would not be possible or practicable to ensure 100% compliance by the 1,400 major corporate groups. In fact, in a complex dynamic environment, where tax law may have been created in a compartmentalised way and subject to various political pressures and limited Parliamentary time, there will inevitably be elements of uncertainty. Sometimes it will be hard to say what compliance with the law really means, and there may be areas in which the company tax regime lacks coherence or sufficient alignment with the competitive market system in which it has to operate.

The extent to which the ATO is achieving its statutory mandate depends on how good its strategic focus is, how efficient and effective the coverage it is able to achieve of the 1,400 major economic groups really is, and how much is left uncovered or insufficiently covered.

[162] The population size and turnover threshold are taken from the ATO publication "Tax and Corporate Australia", published at www.ato.gov.au/taxcorpaustralia and last modified on 11 October 2017.

In order to optimise the company tax base the ATO needs to articulate a definition of what would constitute the key elements of success in that regard, including through a series of measures. If the elements of success are not understood and measurable the ATO will not achieve its full potential. Applying the systemic analysis framework in Chapter 2 to this issue, it seems that the ATO as administrator needs to be able to answer four sets of strategic questions:

(i) How well does the ATO know the environment in which multinational companies operate and how well is the ATO positioned within that environment to deal with tax avoidance and non-compliance?

(ii) How is the company tax code performing in terms of defining a coherent and robust tax base and in delivering sustainable revenue that is aligned with the economic profits multinational groups earn in Australia; and, in this regard, are the tax concessions working as intended?

(iii) How are the ATO programs in relation to multinational groups performing in terms of their efficiency, effectiveness and overall balance in optimising the company tax base as defined by law?

(iv) Does the ATO have good working relationships with key stakeholders; are they based on realistic expectations and appropriate differentiation; and are they conducive to the ATO role as a regulator tasked with optimising the company tax base?

These four strategic questions are interrelated and the process of using them to form an overall assessment of the extent to which the ATO is optimising the tax base in relation to the 1,400 major corporate groups is therefore an iterative one, each of these sets of questions presenting a different window on the same system.

Strategic effectiveness should not be seen as a busyness test. There is a myriad of products, services and processes that the ATO undertakes but the real question is what difference is the ATO making. This requires a relatively smaller number of important measures that would convince an objective independent observer that the ATO strategies and their implementation are enabling the ATO to continuously improve its performance and to effectively identify and address the instances of non-compliance having a material adverse impact on company tax collections. Those metrics would show a focus on the key ***drivers*** of compliance, with strategies aimed at supporting and locking in the positive drivers and effectively managing the negative forces as best as practicable. Other measures would be needed to show that the ATO was acting professionally in its dealings and keeping the compliance costs for taxpayers and itself as low as practicable, consistent with its statutory mandate.

How well does the ATO understand the business environment and the tax risks?

The ATO's understanding of its operating context and the risks to the company tax system depends on the quality and adequacy of its business and market research and intelligence, its operating processes and its ability to constantly link sectoral and individual case level analysis to discern the aggregate implications for the company tax system.

Where the ATO understands the drivers of tax performance it can position itself strategically to address them, including by reshaping or rebalancing its compliance strategies or suite of products and services, or by advocating timely law improvement. When the ATO is operating at the top of its game it will always know the law changes and process

enhancements that will make the biggest improvements to the operation of the company tax regime. It will discover these priorities by reflecting on what it has learned, in relation to the four sets of strategic questions, from doing its job. (Compare Figure 3 in Chapter 2.) This distillation is an important part of the value that the ATO should add over and above what it does by way of core technical functions. It changes the function of the ATO from merely doing a series of tasks to one where it makes a major ongoing contribution to (re)shaping the company tax system - and gets the work done at the same time.

There are two elements of coverage that are prerequisites to the ATO being well positioned:

(i) A sufficiently broad and detailed ongoing research program and compliance coverage of the 1,400 major economic groups so that their real economic footprint can be ascertained and their profit and tax performance properly evaluated relative to their peers, with due regard being had to economic conditions and current tax policy settings. The coverage could take a number of forms but in combination needs to be fit for the purpose of optimising the company tax base; and

(ii) An understanding of the drivers of tax performance and whether at the individual case level and across the population of the 1,400 economic groups it is explained by reference to economic factors, tax policy settings, tax avoidance or some combination of these.

The health of the company tax system depends on the ATO's ability to **effectively** cover the **whole** patch, identify **all** the material tax risks and address those issues and their **causes**. Time and timing is a resource. Some risk cases will not be able to be addressed once statutory time limits for corrective action expire. To the extent that this kind of coverage is not able to be achieved, for whatever reason, there will be company tax base leakage and the potential for some multinationals to obtain a competitive advantage over taxpayers complying with the law.

In order to be well positioned within its environment the ATO would need to have a fairly reliable and ongoing understanding of its risk pool, both in terms of the overall tax risk and the clusters accounting for the bulk of that risk (the patterns and trends in the language of the Iceberg Model). This then allows the ATO to leverage its efforts, and better assure consistent treatment of similar cases, by systematically dealing with the most significant clusters using Public Rulings, strategic litigation, industry based approaches, remedial legislation and other project based approaches to not only address the cases but also address the causes of the clusters.

While the ATO publication provides a list of the tax risks it is concerned about, which shows that the ATO is doing some good detection work, the strategic question is how complete that discovery is.

Does the ATO understand the performance of the company tax base and the tax gap?

As to the second question, in large part the performance of the company tax system is determined by how much of the theoretical tax base is actually collected, especially if one accepts that the strategic goal of the ATO is to optimise that base. Since there is no model for the company tax system that can give these answers, various exercises are conducted in an attempt to estimate the missing slice of revenue over and above what is voluntarily paid.

It is important to note, though, that some of the theoretical tax base is given away as business tax subsidies, the cost of which do not form part of tax gap calculations.

The usefulness of tax gap measurement has been much debated, as have the numbers that have been produced. There is the temptation that analysts approach the issue in the way that Douglas Adams work, The Hitchhikers' Guide to the Galaxy approached the question of life, the universe and everything; which in that case the supercomputer Deep Thought estimated to be something in the order of 42. The measurement work has to be meaningful. Macro approaches to tax gap measurement present a number of major uncertainties and may not prove very useful; they might bear no relationship to an amount of company tax revenue that might reasonably be able to be collected. These methodologies may provide no pathway to the identification of cases with material tax risks and produce sterile debates in which prejudices about multinational groups meet defensive positions promoted by the multinationals and, perhaps, the tax administration.

Arguably the biggest driver of company tax performance is the performance of the Australian economy, usually measured as GDP, though regard is sometimes had to GOS which is discussed below. Importantly therefore, it can reasonably be expected that the tax gap will be impacted by the size and performance of the Australian economy. It will also be impacted by what the ATO does and does not do.

The other observation that can be made about tax gap analysis is that it may be that its usefulness may not lie so much in the soundness of the methodology and accuracy of the numbers as in the direction of the trend in the tax gap, a bit like the wet finger in the wind used to determine its direction, due allowance being made for movements in the Australian economy.

That said, the Iceberg Model framework explained in Chapter 2 provides both a diagnostic for evaluating how the law is going, and a methodology for improving outcomes. It provides a basis for improving the judgments that can be made. The key insight is the connection that exists in the real world between the big picture and what happens at the micro level of individual multinational groups. Recognising this natural relationship enables a more realistic estimate to be made on the basis of a bottom up analysis and, because of that connection, it provides a pathway to the cases with material tax risk – so they and the causes of those risks can be addressed. The compilation could be undertaken as part of the core responsibility of regularly risk assessing the 1,400 groups. It dovetails with the ATO program of annual surveys and interviews (which need to be significantly expanded) and the publishing of the annual "Report of entity tax information".

Since the company tax rules are the articulation of the company tax base, an evaluation of how the law is going will inevitably entail an assessment of whether company tax collections from each of the 1,400 major corporate groups and across that sub-demographic as a whole are aligning with the relevant indicators of underlying economic performance and policymakers' expectations as to the revenue impacts of tax concessions.

The patterns and trends in the tax technical issues arising in the transactional flows within the ATO's core compliance and taxpayer assistance processes, and the amounts of company tax associated with those issues, will give a good idea of the known risk pool. These are the relevant patterns and trends within the Iceberg Model framework. This is a good starting point for the evaluation, and the ATO is likely to have a fairly good sense of the present

position, should it do the systematic analysis. The numbers and patterns of audit settlements, disputation and the outcomes of cases referred on appeal will provide further insights – and demonstrate further behaviours between multinational groups and the ATO. An important by-product of this first stage evaluation is that the ATO is then in a position to know whether it is allocating its resources to the most important cases and issues **that have been identified**. However, this will not answer the question of whether all the material tax risks were identified across the full taxpayer population. That would require full coverage and the case level diagnostics, team support and quality assurance from business and tax technical experts to ensure that all material tax risks are identified and appropriately addressed. But, done correctly, an analysis of the current position will reveal to what extent the large corporate population is left uncovered – and the extent to which the ATO is using cluster approaches in its current work practices to make better progress.

At the case level, the ability of the ATO to understand global business and the competitive market system is critical to reliably assessing the performance of the company tax regime. At this level the Iceberg Model can be used to focus on the patterns and trends occurring within the global value chain and the Australian operations. At a deeper level it can be used to understand whether those patterns and trends are economically driven, business driven or tax driven.

Put simply, the ATO needs to understand the real world of the taxpayer, understand what really happens at each stage its global value chain and the role that the Australian operations play. It needs to understand the governance and central control frameworks used by the group to structure and manage dealings between group members. It needs to compare that with how the group as a whole manages its relationships with external parties and competitors. It needs to be able to distinguish business structures and processes (how business is structured and gets done in the real world) from legal structures and tax planning structures; cutting through any artificial constructs to the underlying economic and commercial realities.

Allied to this is an understanding of the accounting reporting processes used by multinationals to evaluate their economic and financial performance and how this differs from the statutory accounting and reporting processes that operate at the subsidiary levels of the group. This is discussed in Chapter 8. Another important aspect is understanding how the capital markets and corporate financing arrangements work, which are discussed in detail in Chapters 5 and 6. In terms of financial statements of the Australian subsidiaries, the focus needs to be on the big numbers and rates of change in the balance sheet, the profit and loss statement, the gross and net cashflows over, say a period of five years or whatever is a normal business cycle. The ATO has to conceptualise the business in terms of a financial model and identify the patterns and trends in the financial statements and what is driving those patterns and trends. While risk assessment of a single year may provide some insights, the necessary understanding of a taxpayer's business will only come from the analysis of a series of years. Single year risk assessments without the full financial context run the risk of missing major tax risks.

The ATO's success in identifying tax risk depends on its ability identify a multinational group's **real economic footprint** in Australia and to identify the parts of the company tax law that are materially relevant to its operations and structures. The ATO needs to construct the narrative of the multinational's business. It also needs to be able to construct the narrative about what the materially relevant parts of the tax law are trying to achieve. This

second narrative begins with the terms of the legislation and involves testing whether the building blocks of the law are doing the job they were meant to do and whether they form a coherent tax base that is robust and sustainable. From those two narratives the ATO can identify the tax risks relevant to a taxpayer's business operations, and communicate them in a way that assists the formation of an information gathering strategy and the development of a sound rationale for any tax adjustments. Where the provisions and relevant building blocks produce the intended outcome, the mechanics of those provisions guide the gathering of evidence and the marshalling of arguments to support their application. It is also part of the ATO's role to identify anomalies in the operation of Australia's company tax regime. Where the law under-reaches it is in effect providing tax subsidies; where it overreaches it interferes in the legitimate operations of markets. Both need to be addressed by law improvement. The concepts and rationale are discussed in Chapter 2. [163]

Since the bottom up estimate as being proposed in this paper is based on actual cases, and allows for the case level data to be adjusted to take account of the real economic footprint and market rates of return, material system-wide risks can be traced back to the source data and the particular multinational groups involved. This is consistent with the systemic analysis framework represented by the Iceberg Model. While there would be a significant amount of work involved, it seems feasible to adopt a bottom up profiling approach, given the population of 1,400 major corporate groups (albeit they comprise 7,500 tax reporting entities).

Where an analysis is framed exclusively on macro level data that is disconnected from the entity level (sometimes referred to as a "top down approach") it is very difficult, if not impossible, to adjust for underlying economic realities at the firm level and this lack of connectivity prevents peer comparisons or the analysis of tax performance on a distributed basis across the whole population of 1,400 groups. The potential problems with this approach can be seen when one reflects on how the ATO has presented its view that the tax performance of large corporate groups matches their economic performance. If profit has been shifted out of Australia, to the extent these macro level analyses rely on aggregated reported accounting data they will be unable to measure what is not included without objective measures for economic activity and profit at the firm level (or a reasonably based surrogate measure) that can be used as a counterfactual against which the reliability of the reported accounting profits can be assessed. As discussed below, the ATO has not yet presented an analysis of how its methodology in taking account of compliance case results adequately addresses this aspect. It can readily be anticipated that unless an estimate of the tax gap published by the ATO has a demonstrably sound rational basis the ensuing criticism will become a distraction to the real work of measuring and optimising the company tax base.

In terms of the measures that may be useful in relation to evaluating the tax performance of particular multinational groups, while there is much debate about what effective tax rate analysis tells about company and tax system performance, it is a generally accepted measure used by businesses. (See the discussion in Chapter 9.) It is most reliable when assessed at the consolidated group level, especially when the group is listed on a reputable stock exchange, or by reference to management data that the group itself uses to run the business and evaluate its performance. Nevertheless, it can provide an estimate of tax risk at the

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[163] See the sections in Chapter 2 entitled: *The "Iceberg Model" and criteria for evaluating Australia's company tax regime*; and, *Dysfunctional effects of non-alignment of tax policy and the competitive market system.*

subsidiary level if the data can be adjusted by reference to objective measures of profit and profitability. These objective measures ensure that the measurement of the profit takes account of relevant trends in the economy and financial markets that impact on the profitability of the Australian operations. Other measures used by businesses themselves to evaluate the performance of their investments, or used within the competitive market system to evaluate the financial performance of market participants (for example by the rating agencies and market analysts) could provide further insights. Multinationals will have internal reporting and evaluation processes to inform the board of directors about the basis of business plans and budgets, their achievability, and performance against those plans and budgets. Financial results and rates of return will typically be evaluated across a range of measures like return on equity, earnings per share, return on assets and other measures important to the kind of business being conducted. These are discussed in Chapters 4 and 5. In Chapter 8 there is a discussion of data integrity issues that are relevant in assessing economic and tax system performance that should be borne in mind in the present context, including different measures effective tax rates that might be useful at the level of group subsidiaries, either individually or as a basket of measures. Chapter 9 explores a data set that would be useful in identifying tax risks and their tax system impacts.

Recently the ATO published a tax gap estimate of $2.5 billion in relation to the 1,400 major corporate groups[164]. The ATO appropriately notes the imprecise nature of estimates subject to limitations and have a margin of error. They state that the estimate has been reached using a bottom up methodology. However, for the reasons set out hereunder, the methodology seems to lack the rigorous use of independent profit measures at the case level, being based on aggregated case level data that has been adjusted somehow in the light of results the ATO has obtained from its compliance program. Nevertheless, if this is presently the only available basis for any kind of a rational estimate it is preferable that it is used for the time being as something of a baseline measure for trend analysis while more refined approaches are explored.

The ATO has published a paper entitled, Large corporate groups income tax gap, in which it sets out its estimates of the gross and net tax gap in each of the income years 2008-09 to 2014-15. The ATO defines these gaps measures in the following terms: "The gross gap is prior to active compliance activities and the net gap is post active compliance". The relevant estimates are set out in Table 7 below. The ATO observes that "[t]he gap primarily reflects differences in the interpretation of complex areas of the law". Arguably this could be said about any case where a large corporate takes a different view of how the law works to that of the ATO, and the taxpayer can pass the relatively low threshold of having a triable issue, especially since tax planning will invariably involve the use of legal structures and the development of technical arguments that the law works in the taxpayer's favour.

The paper also sets out the methodology used to derive the estimates, which the ATO describes as "a bottom-up illustrative approach". The ATO states its objective as being "to estimate the theoretical net large corporate groups tax gap". The usefulness of theoretical approaches relative to more rigorous case level risk assessments of each of the 1,400 major economic groups is discussed in more detail later in this Chapter.

The ATO argues that "[t]he bottom up approach is considered most suitable given the nature of the market, the design of the tax, and the data available" and that "[t]here is no

[164] Tax and Corporate Australia, ATO, October 2017.

independent data source that would enable a top-down estimate to provide a suitably reliable and credible estimate". This reflects the view adopted in this paper but it raises questions as to why the ATO presented unadjusted aggregated data analyses in its publication Tax and Corporate Australia to support its professed confidence in the tax compliance of large corporate groups.

TABLE 7

Income tax gap – large corporate groups 2008–09 to 2014–15[(a)]

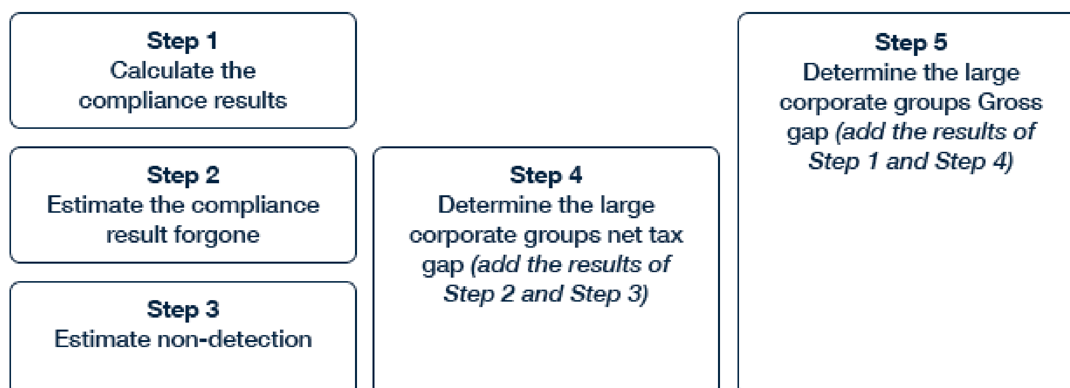
	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
$m							
Tax reported	39,794	33,543	40,896	44,123	40,736	48,208	40,728
Gross gap	3,876	3,110	2,744	3,777	3,487	4,127	3,487
Adjustments	1,214	766	715	1,041	961	1,138	961
Net gap	2,662	2,344	2,029	2,736	2,526	2,989	2,526
%							
Gross gap	9.1%	8.7%	6.4%	8.1%	8.1%	8.1%	8.1%
Net gap	6.3%	6.5%	4.7%	5.8%	5.8%	5.8%	5.8%

Source: Large corporate groups income tax gap, www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/, last modified 11 October 2017.

The ATO explains that it used actual amendment records for the income years 2008-09 to 2010-11 to calculate a tax gap for each of those years, producing net gap percentages of 6.3%, 6.5% and 4.7% respectively. The average of these three years is 5.83% which appears to have then been rounded down and extrapolated as 5.8% for the each of the 2011-12 through to 2014-15 income years. Time lags in the finalisation of active compliance activities and outcomes in relation to those years required that extrapolation since providing no allowance for late payments in respect of those later years would have been much more distorting in the calculation of the respective tax gap percentages.

The ATO paper sets out the following steps in deriving the tax gap estimates:

FIGURE 4



Source: Large corporate groups income tax gap, www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/, last modified 11 October 2017.

The ATO then explains what is involved in each of the five steps in the following terms and includes a table demonstrating the calculation of the theoretical liability and gross and net tax gap amounts for each of the 2008-09 to 2014-15 income years:

> ***Step 1: Calculate the compliance results***
>
> The results of our compliance activities are used to estimate the tax gap for the entire population. We use:
>
> - the actual result of compliance activities, including the adjustments from completed audits and reviews
> - the projected results of open audits and reviews (including objections)
> - taxpayer voluntary disclosures.
>
> Also, as not all compliance activity for the year is completed when forming the estimate, we adjust for taxes in dispute, mutual agreement procedure cases and cases still in progress.
>
> We then sum all net positive compliance results for the population to determine the total compliance result.
>
> ***Step 2: Estimate the compliance result forgone***
>
> Information from our compliance and other engagement activities is used to estimate the proportion of the tax base covered.
>
> The compliance result forgone is the additional tax expected to be raised if the ATO undertook compliance activity on the tax base that was not covered.
>
> We calculate average compliance yields on tax covered by compliance cases (total compliance results divided by total tax covered by compliance cases).
>
> We then use this to estimate the compliance yields on tax not covered. A yield reduction discount factor is applied to this estimate. This is to factor in the assumed lower risk for those not covered by our compliance activities. This reflects the fact that our compliance activities are targeted to areas of higher risk.
>
> To calculate the compliance result forgone in each year, we multiply tax not covered by the estimated compliance yield on tax covered by compliance cases.

Step 3: Estimate non-detection
The exact level of non-detection error in the large corporate group population is currently unknown. Therefore, we include an illustrative figure based on expert opinion and operational data. This shows the impact of a given level of non-detection. Non detection errors apply to both compliance results and compliance results foregone.
Step 4: Determine the large corporate groups net tax gap
We combine the final results determined in steps two and three to arrive at the net tax gap.
Step 5: Combine the components to obtain the gross tax gap and theoretical liability
Next we sum all results from steps one to three to determine the large corporate groups gross tax gap. We then bring in the tax payable amount and add the gross gap to determine the theoretical liability.

TABLE 8

Summary of estimation process ($ millions) by project period

Step	Description	2008–09 $m	2009–10 $m	2010–11 $m	2011–12 $m	2012–13 $m	2013–14 $m	2014–15 $m
1	Compliance result	1,214	767	715	1,041	961	1,137	961
2 to 4	Net gap (estimate of compliance result forgone and non-detection)	2,662	2,344	2,029	2,736	2,526	2,989	2,526
5.1	Gross tax gap	3,876	3,110	2,744	3,777	3,487	4,127	3,487
5.2	Tax payable	38,580	32,777	40,181	43,082	39,775	47,070	39,767
5.3	Theoretical liability	42,456	35,887	42,925	46,859	43,262	51,197	43,254

Source: Large corporate groups income tax gap, www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/, last modified 11 October 2017.

The ATO openly acknowledges that there are limitations in its methodology and rates the reliability of its tax gap estimates as “medium”. It specifically mentions that the estimates do not take account for differences where there are alternative views as to the appropriate interpretation of the law. It notes the fact that the extent of non-detection is unknown and extremely challenging to measure. It explains that the methodology only provides an aggregated estimate of the tax gap and doesn’t measure relative risk between corporate groups or between particular issues within the large business market.

The ATO sets out the following assumptions used to construct the illustrative estimate, noting they are informed by actual data and expert opinion:

- For large corporate groups we don't audit or review – we assume that
  - a certain degree of non–compliance with tax law occurs
  - the degree of non-compliance in these groups is less than those we do audit or review due to our risk-based approaches to engagement.
- For large corporate groups we do audit or review – we assume that
  - adjustments to their tax liabilities are representative of the value of non–compliance with tax law
  - we don't detect all instances of non-compliance
  - adjustments to their tax liabilities from completed audits and reviews are correct at law, at the time of estimation.
- For projected estimates – we assume that
  - past outcomes of audits, reviews, settlements and objections are accurate representations of future outcomes.

The following observations can be made in relation to these assumptions. First, the assumption that the degree of non-compliance with groups that are not audited or reviewed is less than those that are reviewed is open but contestable. It sits uneasily with the observation that the extent of non-detection is unknown and extremely challenging to measure and the observation that in cases subject to audit or review not all instances of non-compliance are detected.

Secondly, the assumption that the additional tax liabilities ensuing from audits and reviews are representative of the value of non-compliance does not seem to have regard that many of those additional liabilities have been determined in the course of settlements between the ATO and the relevant taxpayers. Table 9 below shows the significant impact that settlements have on initially asserted liabilities and cases where the additional liabilities between the parties are settled before amended assessments are raised present another dimension.

Thirdly, the use of historical outcomes in audits, reviews, settlements and objections as a basis for projecting future outcomes assumes that the ATO will not be able to materially improve its risk of detection or its coverage of the large business population.

Fourthly, the ATO has not published the bases it has used for adjusting compliance results for the risk of non-detection or discounting the quantification of risk extrapolated to cases not subject to audit or review.

The $2.5 billion estimate will no doubt be the subject of debate, particularly given that the size of the Australian economy being measured in the trillions, with a significant share of GDP being derived by foreign based multinationals and Australian private groups that do not have the same market accountability for the reporting of their financial results as Australian public companies. The ATO paper, Large corporate groups income tax gap, states that "[i]n 2014-15 large corporate groups reported $1.5 trillion in gross income and paid approximately $41 billion in tax". This represents that on average company tax accounted for around 2.73% of the total gross income reported, bearing in mind that the gross income reported does not take account of transfer pricing effects where products and services are supplied to offshore

associates at less than market prices. There are other factors that raise questions: the declining trend in company tax collections between 2013-14 and 2015-16 while tax on individuals and consumption are trending up (see Table 1); sustained growth in the Australian economy (see Table 6); reported company profits; the incidence of loss cases in the published ATO reports of entity tax information for 2013-14 and 2014-15, a growing share of company profit going to capital. Parliamentary hearings have also heightened the public awareness of global tax planning by multinational groups. However, it needs to be recognised how difficult tax gap measurement is. It also needs to be recognised that the extent of the information contained in the ATO publication is likely to stimulate some useful debate that will enable their analyses to be refined over time. The comments in this paper are offered in the hope that they will assist that further work.

Given the methodology used and its admitted limitations, given publicly known disputes involving significant amounts of tax, the likelihood of similar cases, the list of tax risks identified in the ATO publication and other matters coming to public attention, it would seem to be difficult for the ATO to say that the tax gap might not be twice or three times the published estimate. Moreover, there may be material risk cases or material issues in current audits that are yet to be identified. As the ATO states, the extent of non-detection is unknown and extremely challenging to measure. The answer to this seems to lie in more extensive and better coverage of the large business population.

The general observation can be made that the ATO has not published in anonymised format all the data that it systematically collects. Knowledge of the incidence of dealings with tax havens and low tax jurisdictions, the nature and extent of related party cross-border dealings, the information contained in tax reconciliation statements provided with tax returns, and the learnings gleaned from performing its core functions should provide the ATO with important additional insights into which cases and issues present material tax risks.

While the ATO publication has included aggregate data on the income and profits reported by the 1,400 major corporate groups, it is not presented with observations or caveats regarding its reliability. The reader is left to make their own sense of what it might mean, though it can be implied from its inclusion that the ATO sees the information as supporting its conclusion that “[the] tax performance of large corporate groups matches their economic performance”. However, to take an example, the macro-level analysis of total company tax collections relative to corporate GOS, which could be read as a comparison of total company tax collections with a figure approximating an aggregated EBITDA, is likely to be based on data reported by the relevant companies in their financial statements.

If these observations are correct, the analysis can be interpreted as using benchmark profit level that is likely to be understated to the extent multinational groups have engaged in certain forms of profit shifting. For example if the Australian business pays excessive charges for trading stock or royalty payments to offshore associates, receives a disproportionate allocation of global overheads or is forced to absorb losses (whether those losses are economic losses incurred elsewhere or paper losses) or sells its production to offshore associates at lower than arm’s length prices the GOS/EBITDA will be understated.

The GOS/EBITDA is also calculated before allowance for depreciation/amortisation, funding costs which reduce the accounting profit, the extent of the impact depending on the capital intensity of the Australian business and the degree to which the Australian business is funded with debt. Those impacts may be increased if the multinational group seeks to inflate the

value of depreciable assets or the interest rate charged on intra-group loans, which in turn will result in lower company tax collections.

One of the difficulties with the comparison of total company tax collections to GOS is that both the integers used in the comparison may be understated.

Moreover, tax concessions impact on both the calculation of taxable income and the amount of company tax payable. The company tax collections will reflect the tax reconciliation adjustments and be net of tax credits and offsets, and are therefore likely to be a lower proportion of accounting profits, assuming they are accurately reported.

Another difficulty in interpreting the analysis is the enormous effect that the largest multinationals have on total company tax collections and GOS, especially the Australian based publicly listed groups that pay significant levels of franked dividends. The analysis is likely to look markedly different if, say, the top 50 or 100 economic groups were excluded; or foreign based and Australian private groups were separately analysed.

Taking these factors into account there seems to be a risk of endogeneity in this analysis; it will not be able to reveal what is not there within the data sets being used. To that extent the tax and EBITDA performance of multinationals will look better than they really are. It seems self evident that in all tax gap measurement work reliability depends on supplementing reported profit analysis with objective measures of income, profits, expenditure levels and assets (or reasonable but conservative proxies) to verify the real economic footprint in Australia and test the reported profit performance to see if it is commercially realistic given the annualised investment the multinational has made to earn it. (See Chapters 8 and 9.) It is therefore unclear what, if anything, is able to be confidently drawn from the published information in terms of tax compliance or tax base performance.

As alluded to above, the analysis may yield some differences if applied to Australian based multinationals compared to foreign based multinationals as a separate sub-demographic and to Australian based private companies as a further subset. The ATO publication notes "an observable long term correlation between the pre-tax profits of publicly listed businesses (sourced from their financial reports) and their tax payable (sourced from their tax returns)". Presumably the ATO was able to make some adjustment to exclude the tax exempt foreign source profits from the EBITDA component. Distributional analysis within each of these sub-demographics will in any event provide more insights that are now obscured by the aggregation and indexation and is likely to assist in identifying the anomalous cases. There seems to be a hint in the data published in relation to the profit to total income for each of these sub-demographics, showing that profit as a percentage of total income is 10.8% for Australian public companies, 8% for foreign owned companies and 6.4% for Australian private companies, that the incidence of tax avoidance may be more weighted towards foreign based multinationals and Australian private companies. That said, there has been plenty of publicity in recent times about the tax strategies of some ASX listed entities so it may be more a question of relative intensity of non-compliance across the three sub-demographics. Without objective measures of profit for each of these sub-demographics it is unclear what, if anything, in terms of the levels of tax compliance derives from the comparison of company tax collections with corporate GOS (or EBITDA).

The ATO has also noted that the additional income tax collected from large corporate groups through compliance activity is less than 6% of the aggregate income tax they paid

voluntarily. It is unclear how this might be relevant to the question of whether the company tax base is being optimised beyond the obvious conclusion that not all of the company tax collections were voluntarily paid. To make a judgment about levels of compliance, data on the extent and effectiveness of ATO audit coverage, the quality of the audit tax risk identification and resolution processes, and the soundness of the ATO approach to important aspects like the operation of Australia's transfer pricing rules and penalties regime would need to be considered. Again, tax performance at the firm level would need to be tested by reference to objective measures of profitability, based on arm's length dealings within the operations of the competitive market system, and by reference to whether the reported profit results appear commercially rational outcomes having regard to the functions, assets and risks on the Australian side. The impacts of tax concessions, tax expenditures and tax offsets in relation to each major corporate group would also need to be considered. Because some tax concessions, like thin capitalisation and the section 25-90 concessions for flow through financing, have the effect of reducing the Australian accounting profit, they would not be highlighted in the tax reconciliation process but may be identified through the data in other tax return schedules.

The comparison of income tax payable and pre-tax profits of ASX-listed companies shows a broad correlation, but intuitively one would expect there to be a close relationship between pre-tax profits and income tax payable, subject to tax reconciliation adjustments, tax offsets and the impacts of any arrangements to shift taxable profits or make them disappear for Australian tax purposes. One potential issue with this type of analysis, which is likely to be a somewhat lower risk with ASX-listed companies given their greater public transparency, accountability and need for franking credits, is that the aggregation (and indexation) of data obscures the spread of tax performances of individual corporate groups. For example, if the most economically significant of the ASX-listed population are relatively more compliant (for example, through franking requirements associated with their dividend policies and share prices) the Pareto effect has the potential to mute the impact of any cases with relatively egregious tax performance. The points of divergence in the comparison depicted in the graphs are not explained. However, the clear suggestion made by the inclusion of this analysis is that ASX-listed companies are likely to be fairly compliant, which accords with the analysis in this paper. This is not to say that major tax compliance issues will not arise, as shown in the press coverage of recent disputes between the ATO and large companies, though Australia's imputation system provides an incentive to return at least enough taxable profit in Australia to allow for the franking of dividends.

The issues raised in the preceding comments come back the central question of data integrity at the level of the accounting financial statements and tax returns for each of the 7,500 tax reporting entities that the ATO publication says make up the 1,400 major corporate groups. Were that to be tested as outlined in this paper the analyses published by the ATO would have much greater weight.

The trend in company tax collections from the 1,400 corporate groups and the trend in effective tax rates would, with whatever necessary caveats, assist the analysis of how the company tax system is performing. Where those effective tax rates are relatively low compared to the statutory rate of 30% questions would arise regarding the impacts of tax reconciliation adjustment items and tax avoidance, both of which are strategic issues for Australia's company tax base. The ATO systematically collects data on tax reconciliation adjustments through the company tax return and these impacts could be analysed for Australian public companies, Australian private companies and foreign owned companies

and presented in an anonymised format. The data on the tax exempt foreign earnings of each of these sub-demographics would give a better sense of the extent to which multinational groups are deriving their profits from Australian sources, which is the primary basis for Australia's company tax regime (see Chapter 2).

In considering estimates of the tax gap by reference to the objective of optimising the tax base there will always be a practical "floor", above zero, below which it would not be practicable to collect the estimated tax shortfall. That said, it would not be acceptable in public policy terms if there was a material amount of the company tax base that could not be collected due to resource limitations placed on the ATO (or within the ATO unless higher tax risk work was being addressed). Were that to be the case there would be a general expectation that the ATO would seek more resources.

There are two aspects of the observations on tax technical issues contained in the ATO publication that deserve further consideration. These are raised because they go to the basis on which the tax gap has to be estimated and the consequences that may ensue from an understatement of taxable profits. They are also significant in relation to tax risk management, majors risk identified by the ATO in relation to deliberate avoidance included profit shifting. First, the concept of a "reasonably arguable position" is much debated and should be further considered. Chapter 6 includes a discussion of the implications of the *SNF (Australia)* and *Chevron Cases* for the operation of the penalty provisions, those cases suggesting that a wider range of taxpayers may have adopted positions that are not reasonably arguable. While the Commissioner has to take a position on whether the taxpayer has a reasonably arguable position at the time of assessing whether the ATO forms a view as to whether there is any penalty, it is only when a court makes findings of fact and law and evaluates the comparative strength of the opposing arguments that the basis for a penalty assessment becomes crystallised. It is important that a rigorous analysis be done as to whether a rational basis for a reasonably arguable position has been made out, given the important public policy objectives underpinning the penalties regime. The taxpayer has to show that on the facts and law, having regard to the relevant authorities, the position it is arguing for is about as likely as not to be correct, or is more likely to be correct than incorrect[165]. There seems to be a real risk that contrived arrangements, artificial constructs, will not meet this standard, especially in a context where the statutory rules being applied are framed on the basis of real world commercially rational dealing.

There are delicate issues of reputation risk associated with how the ATO administers the penalties regime. The ATO believes that most compliance activity cases "involved "reasonably arguable" interpretations of tax law" and this is why "limited penalties applied to large corporate groups subject to audit adjustments". This may well be the case. However, it would be relevant to know what quality assurance work is done in relation to the application of the penalties regime (particularly in relation to comparing the approaches taken by the Courts and those taken by the ATO) and whether amended assessments included higher levels of penalties that were subsequently reduced when audit cases were settled.

[165] Subsection 284-15(1) of Schedule 1 of the *Taxation Administration Act 1953* provides:
A matter is ***reasonably arguable*** if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.

Secondly, the example of the inbound supply chain in the ATO publication is necessarily somewhat shorthand, but it does not provide any basis for a view that a 24% profit for sales, distribution and after sales support is reasonable having regard to the way that the arm's length principle in Division 815 and Australia's treaties applies in practice. When regard is had to the economic functions, assets and risks on the Australian side, one possibility is that the design and manufacturing intangibles may be shown not deliver the functionality and quality needed for market leadership. In such a case it is likely that a marketing distributor would have to work harder for its sales and that the products would not bear as high a selling price as those of the market leaders. A market survey of independent marketing distribution companies would seem to be a necessary step in applying the arm's length principle. The market rate of return so determined for the functionality on the Australian side may well be different from a proportional share of the channel profit. The example is open to the reading that the transfer pricing rules operate on the basis that channel profits and channel losses are shared between the different stages of the value chain. As highlighted in Chapter 2 in the section entitled, *Understanding the economic value chains of multinational groups and how tax rules impact*, the economic and competitive forces impact in a different way within multinational groups because they do not have to allocate commercial margins to the various stages of their value chain. The *SNF (Australia) Case*, which was not overruled in the *Chevron Case*, seems to be clear authority for the view that the margin to be accorded to the Australian operations does not depend on the multinational group's ability to afford an arm's length rate, or its propensity to pay it. Moreover, Australia's treaties and Subdivision 815-B operate on the basis of a hypothetical that is framed in terms of the conditions that operate between two enterprises (entities) in (in connection with) their commercial or financial relations that differ from those which might be expected to have operated between independent enterprises (or entities) dealing wholly independently with one another (in comparable circumstances). [The differences in wording in subdivision 815-B compared to the treaties are shown in parenthesis.] The application of the arm's length principle is accepted as involving a benchmarking of the actual arrangements with an independent comparable and this can impact on the calculation of the arm's length profit attributed. For example, a particular part of the channel may be adding economic value, and independent comparable benchmarks may be found for a positive rate of return, even though the channel is in overall loss.

Returning to the issue of tax gap analysis, provided it is directed to obtaining useful information about the performance of the company tax regime, it is an area worthy of further research. It will now no doubt gain impetus thanks to the disclosures made by the ATO, and will no doubt develop through collaboration between the ATO and eminent research institutions, something that was recommended in the Henry Review[166] and more recently by the OECD/G20 in their work on measuring and monitoring base erosion and profit shifting[167].

It should be noted that the ATO tax gap estimate is in the nature of an estimate of the shortfall figure for one particular year. The Budget shortfall increases the longer the tax gap remains untreated and prior income years that are still open to amendment will each have their own tax gap. This is evident from the ATO data set out in Tables 7 and 8 above. Secondly, the tax gap as defined does not take account of penalties or interest that may be

[166] Recommendation 133, Chapter 12, *Australia's future tax system*.
[167] Measuring and Monitoring BEPS, Action Item 11: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Chapter 4, OECD Publishing, Paris, 2015.

payable on a tax adjustment; so, the full consolidated revenue effect of ATO audit activity and the real value of the underpayments of tax is not covered. Thirdly, the tax gap estimate, by definition, excludes the revenue impacts of weaknesses in the law and instances where tax concessions may be overly generous or ineffective (referred to by the ATO in Large corporate groups income tax gap as the "policy gap"). Areas suggested for policy review have been summarised in Chapter 12.

One question that arises from the information published by the ATO in relation to the tax consolidation regime is why 1,400 major economic groups have 7,500 tax reporting entities. On its face this seems inconsistent with the notion of a single economic count of the financial components related to determining the profitability of business activity conducted in Australia. A key design goal in tax consolidation was to reduce the scope for tax avoidance through the use of intra-group arrangements. This aspect warrants further examination given the arm's length principle does not apply to domestic dealings (which would include dealings between tax consolidated groups that have a common underlying ownership).

The efficiency, effectiveness and overall balance of ATO compliance strategies

The third question about the efficiency, effectiveness and overall balance of ATO compliance strategies, products and processes depends on the existence of appropriate governance and quality assurance, supported by metrics that would give confidence that all material risks to the corporate tax base are being identified and effectively addressed in a timely way and also that taxpayers get the help and advice they need on a timely basis.

Some of the headline numbers in the ATO publication would benefit from further examination. In relation to its resourcing levels, the ATO publication states that the ATO has over 1,300 staff allocated to assisting and assuring the compliance of 1,400 large corporate groups comprising 7,500 tax reporting entities and around 30,000 active companies. While stating that the vast majority of these staff are focussed on assurance, the publication does not include a break-up of staff allocated by core function, or between operatives and administration. Even on a flat reading the resourcing allocated within the ATO to this important sub-demographic would appear to be stretched to marshal very many audit teams to cover the 1,400 groups on a regular basis. This needs further consideration because it is reasonable to assume that the perceived level of expertise and resourcing of the Australian Taxation Office (ATO) relative to private sector capabilities is a factor that multinationals take into account in doing their tax risk assessments and provisioning for future tax expense. Coverage has to be of a sufficient level and intensity to convey to all stakeholders that there is a high probability that material tax risks will be detected.

It would be important to also understand the ATO's plan for achieving effective coverage of the full population of 1,400 groups, the 7,500 tax reporting entities and the 30,000 active corporations. All these groups have been classified as major and should be subject to detailed coverage given their economic significance relative to other taxpayer demographics, their complexity, and the likelihood that they may have international structures and cross border related party dealings involving low tax jurisdictions. To some extent the report states that this is done by computer screening, "applying risk rules to quantitative data". There is also mention of one to one engagement with the largest 100 large corporate groups, which are described as involving "detailed one on one reviews" a process that the ATO intends extending beyond the top 100 once additional resources become available. However, the

current proposal is that coverage of groups below the top 100 groups "occur on a four year cycle".

Since there will be a lead time following the issue of income tax assessments in assembling data for risk assessment purposes, allocating ATO resources and collecting and analysing the necessary information, providing statements of audit positions to taxpayers and obtaining their responses, there is a real risk that detailed coverage of groups below the top 100 will not be completed within the standard statutory time limit of four years provided in subsection 170(1) Item 4 of the *Income Tax Assessment Act 1936*. Non-current information may be harder for companies to retrieve and relevant company officers may no longer be with the company. While extensions of time can be obtained in accordance with subsection 170(7) by order of the Federal Court or with the consent of the taxpayer if requested before the expiry of the relevant statutory amendment period, it cannot be expected that they will be automatically granted. One could read into the standard statutory time limit that there is an expectation that most issues, other than transfer pricing cases and those involving fraud or evasion, would be completed within four years of the original assessment being served. Longer time limits for issues like transfer pricing[168] and fraud and evasion[169] are given because investigations are likely to take longer and possibly involve other jurisdictions, and because the Commissioner will not be able to tackle fraud or inadequate disclosure until it is discovered. In any event it would seem to be an inherent part of good tax administration to identify all the material risks promptly, not to have undue delays in actioning those cases, and to collect any underpaid company tax as soon as practicable. Such an approach would dovetail well with the need for a soundly based bottom up methodology for getting a more reliable measure of the tax gap in respect of major corporate groups.

The ATO view that "it will take several years for [its] strategies to be fully reflected in tax gap estimates" leaves it open to criticism and raises questions about the level of resourcing for the range of compliance assurance activities. It could reasonably be expected that with the proper strategic focus and adequate resourcing results would start to flow fairly quickly, which in turn would have positive knock-on effects across the 1,400 population. As yet the ATO has not expressed a view publicly as to the extent of the impact it expects to achieve on the tax gap and past underpayments of company tax.

It would be important for key stakeholders, if not the general public, to understand what comes from computer screening and the detailed reviews of the top 100, the extent to which close scrutiny extends beyond the top 100, to what extent a need for follow up action is indicated in terms of the total stock and flow of tax risks, and to what extent it is able to be resourced. It would be reasonable to expect that an organisation that is in a phase of increasing its data sources/supply and compliance coverage and improving its use of data analytics is likely to identify more cases with material tax risks. One potential operational risk at present is that if there is an internal perceptions of resource constraints it might impact on resourcing the identification of risks beyond the capacity of the organisation to deal with them – another potential risk is that identified cases will remain unallocated. Such a scenario is likely to have material adverse implications for measuring the tax gap and optimising the

[168] Section 815-150 of the *Income Tax Assessment Act 1997* provides a seven year time limit from the date of service of notice of assessment for amended assessments in cases involving profit shifting.
[169] Subsection 170(2) Item 5 of the *Income Tax Assessment Act* 1936 provides there is no time limit for amended assessments in cases where the Commissioner is of the opinion there has been fraud or evasion.

corporate tax base. Coverage needs to be sufficient and effective in identifying all the material tax risks in each of the 1,400 major groups, noting that, on proper checking, some major groups may not present material tax risks.

Part of the criteria for successful stewardship by the ATO must be the identification of all the material tax risks in each of these groups in a timely way so that follow up action can be taken where needed within the statutory time limits for amended assessments. The ATO publication does not as yet give the full ATO narrative on the nature and extent of coverage needed to optimise the company tax base in respect of the 1,400 major corporate groups or provide metrics that would demonstrate the extent to which it has progressed.

The ATO publication states that the top 100 groups collectively pay about half of all corporate income tax. Based on Table 1 this would be in the order of $33 billion in 2014-15 out of the published figure for total collections of $41 billion for 2014-15 for the 1,400 major corporate groups. In other words, the remaining 1,300 corporate groups appear to account for collections in the order of $8 billion, an average of $6.15 million, though there may be a further concentration of tax payments to a relatively small slice of the 1,300 less significant groups. Looking at the participation of Australian public businesses, the report states that they make up 25% of the 1,400 major groups, pay 71% of the corporate income tax payable (which appears to be in the order of $29.1 billion of the $41 billion collected from the full 1,400 groups), and accounts for 55% of the gross income reported as being earned by the 1,400. While the aggregate number for gross income is likely to be reliable, given the importance of accurate reporting and the franking credit benefits for Australian public companies, the remaining 45% of gross income reported for the remaining sub-demographics comprising the 1,400 would need to be tested. Like the data published in relation to profit to total income (discussed above) this data in relation to Australian public companies suggests that the profit and tax performance of Australian public businesses is stronger than that of foreign owned businesses and Australian private businesses. There is no explanation as to why, or whether there are any compliance issues. It does open the possibility that the Australian public companies might (with certain reservations) be something of a peer control group to test the financial and tax outcomes reported by other entities.

The published ATO reports of entity tax information for 2013-14 and 2014-15 show a significant number of entities that paid little or no tax. While some of this reflects entities that pass profits through to stakeholders or beneficiaries and are not taxed in their own right, there is a level of assurance that is needed in respect of the rest to ensure that losses are real economic losses and reflective of arm's length arrangements.

The ATO publication sets out the following results from compliance activities in relation to the 1,400 major economic groups[170].

[170] This data is set out in Table 1 in the ATO publication.

TABLE 9

Corrective action targeting large corporate groups (income tax)

	2011–12	2012–13	2013–14	2014–15	2015–16
Total debits (liabilities)	1,633	2,147	1,602	2,471	1,354
Audit yield (cash)	636	1,852	1,011	1,685	703
Tax losses denied	583	1,539	1,170	1,462	680

Note: liabilities raised in a given year may cover assessment against multiple years of assessments and include interest and penalties

Source: Table 1, Tax and Corporate Australia, ATO, 11 October 2017.

While Table 1 in the ATO publication (Table 9 above) does not say that the reported figures are in the millions of dollars it is clearly sensible to read them that way. The results for 2014-15 stand out as the best of the five years, subject to the outcome of any disputed matters. There are no figures to compare with the ATO statement that "In 2014-15 large corporates reported $41 billion in corporate income tax". There is year on year fluctuation in the figures and the absence of year on year improvement suggests that, notwithstanding the lumpiness of some case outcomes, the underlying productivity of the compliance program is uneven.

Acknowledging the additional liability and collections figures are not insignificant, and would have entailed a great deal of effort, they do not present a basis for suggesting that inroads are being made into the extent of the tax gap. The concern would be the signal that this may send to companies in relation to the level of risk they could assume in the way they manage their tax affairs and how they should handle their dealings with the ATO. Even with what appears to be a conservative estimate of a $2.5 billion tax gap, and the fact that as shown in Tables 7 and 8 there is a tax gap for each of the years covered by Table 9 and for 2016-17, the likelihood is that there is a significant and possibly growing risk pool still to be addressed. In its publication, Large corporate groups income tax gap, the ATO states that "[t]he tax gap trend for large corporate groups has been relatively steady for a number of years"[171]. Given the figures for each year of the program include corrections related multiple years and associated penalties and interest, the inroads that the compliance program is making, even in terms of the conservation estimates of the tax gaps for the 2012-13 and subsequent income years (which are still open to adjustment under the general four year amendment limit) seem to be modest at best, even on the basis of the total debit figures. This

[171] www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/ accessed 1 November 2017.

again raises questions about the level of resources allocated to this work and the risk of non-detection of material tax risks.

The ATO publication does not disclose how much of the liabilities raised as a result of ATO corrective action are now tax in dispute in objections and appeals, which may produce further collections once those matters are determined.

However, at a broad level, the difference between the liabilities and collections does raise questions about the ATO's approach to settlements, especially given that in many cases ATO investigations will take years to complete. Since in that process regard will be had to the relative strength of the ATO's evidence and arguments compared to those of the taxpayer it may also raise a question about the quality of the investigation work leading up to the amended assessments or audit positions that are the subjects of the settlements.

When one analyses all of the information in the ATO publication and takes account of all the contra indications, the ATO expression of confidence in the tax compliance of large corporate groups appears premature and its estimate of the tax gap appears conservative. This is not to say that all multinational groups are bad compliers; there is not enough information to form a view as to the extent to which they are good or bad compliers. It was recognised in the ATO paper, Large corporate groups income tax gap that one of the limitations of the tax gap methodology used was that it doesn't measure relative risk between corporate groups. On the current rate of coverage of the 1,400 major economic groups and the trends in the results of its audit program, even that level of tax gap appears difficult to address.

The effectiveness of ATO relationships with large business

The Iceberg Model casts the evaluation in terms of two sets of behaviours, values and world views: those shown by multinational groups and those exhibited by the ATO. To optimise the tax base the behaviours exhibited by the ATO need to be purposively driven by the objectives of tax risk identification and minimisation. It has to have the right organisational culture and its processes need to be purposefully implemented.

The fourth strategic question goes to the kind of relationship that the ATO has with key stakeholders and how the ATO sees itself in that relationship. For the purposes of the present discussion three stakeholder groups are especially relevant: those with the Government, large businesses and the general community.

The nature of the relationships that the ATO seeks obviously needs to be shaped by its role as administrator and regulator and the strategic objective of optimising the company tax base. No-one else has that authority and responsibility. The role carries significant challenges in understanding and managing the complexity and in being appropriate to the (constantly evolving) context. It is in these respects that a systemic approach is needed.

In so far as large business is concerned, the ATO needs engage in a meaningful and constructive way but maintain the balance and objectivity needed to be able to recognise and appropriately confront behaviours that are not conducive to good compliance, but also to be able to recognise and affirm instances of good corporate citizenship and provide assistance when it is needed. It would be a concern to most observers if the ATO and large business were consistently congratulatory of each other given the natural tensions between the

interests of multinational groups and those of the Australian community. For that reason the level of disputation between large business and the ATO cannot be the barometer of the relationship – or the extent to which the ATO can settle disputes. The nature of those disputes, the outcomes that ensue and the pattern and trend over time also provide important insights into the quality of the relationship and the ATO's ability to stay true to its role and strategic goal.

In some situations the ATO needs to be an advocate for large business, for example in streamlining processes wherever possible and supporting the removal of anomalies in the company tax system that interfere with the legitimate operations of markets. In all circumstances the relationship needs to be professional and purposeful so that its role is not compromised by getting too close or losing focus on its statutory role and strategic objective. While it needs to create a good working relationship, it cannot see its role as being the friend of large business; nor should it be their enemy.

One of the main interactions between the ATO and the large business population is in relation to the gathering of information. The ATO has the power under statute to access whatever information it needs for the purpose of administering the company tax law, some of which is collected systematically through taxpayer registrations, tax returns and associated schedules, some through the company tax payments system, some through rulings requests and other cooperative compliance products, some in the course of field enquiries, including from other tax authorities in some cases.

To a large degree tax administration is a data and information driven function. The ATO needs to use its statutory powers for information collection in a strategic way. The ATO publication contains several references to additional data sources being included in its risk assessment framework for large business, some, like country by country reporting, that have been driven by the OECD/G20 work on Base Erosion and Profit Shifting. Notwithstanding all the existing and proposed data sets the ATO is struggling with the measurement of profit shifting and the tax gap for the large corporate sector. So is the OECD[172]. Something is still missing from the diagnostic modelling.

What systematically collected data set would best assist the ATO to optimise the company tax base? An overall picture needs to be created of the information and the analytical processes needed (in the first phase of compliance activity) to make a reasonably reliable assessment of tax risk at the case level. Otherwise there will be no assurance that the current and proposed information sets are adequate. If the data systematically collected is adequate to make a reasonably reliable assessment of the tax risk in a particular case, the aggregation of those tentatively quantified risks should assist the estimation of the tax gap, which would be more meaningful and of practical use.

A key indicator of the quality of the relationship between the ATO and the 1,400 major economic groups is the turnaround times in cases where the ATO needs further information. This has not been published. Where the relationships are professional and efficient the information gathering phase should be kept to a minimum. This carries expectations of each side. The ATO needs to be able to articulate a risk hypothesis to the multinational group as a basis for its information gathering strategy. Obviously, the risk hypothesis will be refined

[172] Measuring and Monitoring BEPS, Action Item 11: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015.

and evolve as investigations progress and the evidentiary requirements derived from the machinery of the relevant company tax provisions become clearer. However, in the early stages the ATO is entitled to take a broader scope in order to understand the taxpayer's business operations and come to a view as to which parts of the company tax law may give rise to material risks (a process sometimes colloquially referred to as "fishing"). The case level approaches recommended in this paper should allow the information gathering to be targeted efficiently.

The process of collecting the additional information the ATO needs should be structured in a way that manageable blocks of information relevant to the risk hypothesis are requested in stages and that the process is actively managed. In that way the consideration of issues can continue to be progressed rather than have a stop/start process of trying to obtain everything in one go and waiting long periods for the response. Information requests need to be supported by conversations between the parties to clarify any ambiguities or uncertainties and allow options for the information to be supplied in the most efficient way. Discipline is required in logging the requests and the adequacy information supplied in response since this assists the efficient management of the case and can provide evidence of the level of cooperation provided by the taxpayer.

The ATO needs to ensure that its information gathering is hypothesis driven and that it promptly addresses any undue delays on either side and instances where the responses to information requests are inadequate. In the risk assessment stage it is the ATO that is entitled to determine the relevance of any requested information and should be able to articulate the relevance its sees of the requested information to the testing of its risk hypothesis. The ATO needs to be aware of any cases where taxpayers are seeking to deliberately delay the outcome of investigations. Any undue delays in the information collection process accumulate across the compliance program and may seriously impact the ATO's ability to cover the 1,400 major economic groups. However, the ATO should not let standard performance measures of turnaround times prevent it from obtaining the information it needs to properly apply the law. The policy expectation in cases of deliberate delay lie in the penalties, interest and offences provisions of the law and the ATO needs to ensure they are applied appropriately.

Another key interaction between the ATO and the 1,400 major economic groups is in relation to the settlement of disputes on tax technical issues. They provide important insights into how the company tax law is going and whether the Australian community can have confidence in how the ATO is positioning itself in the relationship. The issue that will always arise in the public mind is whether the ATO has achieved the right balance, a judgment that will be influenced by their perception of the appropriateness of the outcomes achieved. There will always be a place for settlements in good tax administration but they will inevitably raise debate within the Australian community. It is important to avoid a culture of "taxation by negotiation" which can reinforce aggressive approaches to tax planning - and towards the ATO - in order to get favourable outcomes. This is likely to happen if the ATO leaves too much on the table and, consciously or not, takes an approach to compromising the primary tax and penalties liabilities that leaves tax planners and multinationals with the impression that there is no real economic downside to aggressive tax planning. The ATO is also likely to face pressure if large amounts are involved and the ATO believes it has a strong case. The public has an interest in litigating cases where there is major uncertainty in the law (assuming it cannot be clarified by remedial legislation, which is often difficult where a retrospective application is needed) and cases where taxpayers have deliberately contrived to circumvent the law. The ATO should also litigate when the

taxpayer does not make a realistic settlement offer. This has been reflected in the ATO's corporate statements about strategic litigation; the proof is always in "the pudding"; the extent that the strategic intent is demonstrated in practice with dispassionate objectivity and professionalism.

The material differences between liabilities raised as a consequence of "corrective action targeting large corporate groups" and the final collections raise questions as to the ATO approach to settlements and the quality of its investigative work.

The distribution of risk issues identified across the respective ATO core processes will also convey insights into the extent to which taxpayers are bringing issues to ATO attention or leaving them to be discovered by the ATO in compliance processes - or whether they are bringing certain types of issues to notice and keeping their tax positions to themselves on others. The difficulties presented by any lack of transparency may be ameliorated to some extent by the ATO initiative of requiring large corporate groups to lodge a "reportable tax position schedule disclosing their approaches on key tax issues and any arrangements [they have entered into that are] covered by a taxpayer alert"[173]. The systematic checking of taxpayer adherence to major ATO public rulings, part of standard ATO audit procedures, would provide further insights were that information to be aggregated and analysed.

It would be unrealistic to approach the administration of the company tax regime without recognising how the tax attributes and commercial interests of shareholders and the accountabilities of senior corporate managers can impact on attitudes to tax compliance. The nature of company tax being an expense that does not create assets or income for a business means that multinational groups will always be considering the most tax efficient ways to do business. The immediacy of the tax impacts on their profit outcomes are likely to outweigh the indirect benefits that multinationals get from Australia's infrastructure, rule of law, skilled workforce and international relations.

The competitive and financial advantages that can accrue to a multinational group from tax minimisation, and the consequential increased rewards that may thereby become available to both shareholders and management, create a dynamic of which the ATO needs to be constantly alert. In applications for tax rulings, tax risk assessment reviews, controversies and policy debates it would be reasonable to expect that multinational groups will draw on their intimate knowledge of business and markets to present their case in the best light. This requires a professional circumspection by ATO and the capabilities to test whether what is being put is driven by the real world economic and business circumstances of the taxpayer, or finds its real explanation in the desire to minimise tax. In an analytical sense, the relationship between the ATO and the 1,400 major economic groups needs to have the professional distance needed to achieve its strategic objective.

[173] Tax and Corporate Australia, ATO, published at www.ato.gov.au/taxcorpaustralia and last modified on 11 October 2017.

Chapter 12 Conclusions

This Chapter reviews the effectiveness of the systemic analysis framework in its application to the range of testing grounds. The application of the systemic analysis framework has been shown to assist in distinguishing between economic, tax policy and tax avoidance drivers and impacts, and provides some important insights. For example, the following observations can be made regarding Australia's positioning in the global economy and the current performance of the domestic economy.

While it is vital that Australia remain competitive for foreign investment, the analysis in Chapter 2 of the long term trend in net foreign investment has not shown changes in the company tax rate to have had any material effect on Australia's ability to attract foreign investment. The trend in net foreign direct investment in Australia compared to changes in the statutory rate of company tax over the period from December 1988 to December 2014 does not disclose a material positive correlation. While the impact of tax concessions in lowering the effective rate of tax is likely to have some level of impact on decisions whether or not to invest, it does not appear to be decisive.

Having regard to the full range of factors affecting decisions relating to direct investment in Australia, which are discussed in Chapter 4, it is evident that the statutory rate of company tax and the effective rate of company tax are only one element of investment decisionmaking and, arguably, do not appear to be dominant in relation to the mainstream of foreign investment. The ongoing strength in the growth of net foreign investment over the period from December 1988 to December 2014 seems to support this view.

Rather the analysis suggests that business investment in Australia is currently being constrained by current conditions in the domestic economy, despite record low rates of interest being conducive to increased business investment for some time now. These include the limited availability of sufficiently attractive business investment opportunities, infrastructure constraints, policy gaps and disagreements within the federal system of government and softness in demand. Infrastructure related to existing and potential forms of transport (road, rail, shipping and motor vehicle), water catchments and distribution and the availability and cost of power supply deserve particular mention. Factors impacting on consumer demand include unemployment and underemployment, slow earnings growth, rising costs of living, household debt levels and bracket creep. This suggests the policy focus should be on stimulating growth in the domestic economy, fostering the development of new industries, promoting regional development, and addressing the factors limiting demand in the domestic economy. These factors need direct and coordinated policy responses.

To use a cut in the statutory rate of company tax in an attempt to address these drivers is likely to be ineffective and very costly in terms of foregone revenue from the current stock of business investment. It would also have the flow-on effect of increasing the personal tax liability of individual shareholders resident in Australia through lower franking, and heighten the challenge in repairing the structural budget deficit. In contrast, it would also raise issues in relation to foreign shareholders and whether Australia would get a fair share of tax.

Moreover, a reduction in the company tax rate at this time raises the question of fairness in relation to the relative contributions of large business, individuals and consumers to Australia's revenue needs, particularly given the increasing trend in individuals tax and GST

and the decline in company tax collections. Other factors such as bracket creep, cost of living pressures and the softness in consumer demand would tend towards tax relief for individuals.

The use of the systemic analysis framework in evaluating the operation of the company tax system identifies key insights in relation to both the code of law and its administration. In relation to the legislative rules that define Australia's company tax base and determine the amount of tax payable, the absence of rigorous cost benefit analyses and measurable tax policy objectives in a range of important areas of tax policy present challenges in ensuring that the company tax base is robust and sustainable. There are features in the present system that can be seen as creating unwarranted tax subsidies and distorting economic efficiency and market competition. It could be argued, having regard to the drivers of business investment, the sources of Australia's competitive advantage, and the fact that current tax settings assist the free flow of debt funding and returns to direct investment, that Australia is leaving too much on the table in terms of tax concessions, more than it can presently afford.

Tightening the current array of tax concessions would increase the economic efficiency of capital allocation within the Australian economy, provide a more competitively neutral tax environment for business and assist Budget repair. Such an approach may also create potential to fund programs for economic growth, including infrastructure investment, the development of new industries and regional development. It would also put Australia in a better position to reduce company tax rates in the future should a sound policy basis emerge. The analysis in Chapters 2, 3, 4, 6 and 8 has also highlighted areas of the company tax code that are not sufficiently aligned with commercial realities and market practice. Because of the greater flexibility in the way Australian subsidiaries can be structured and their assets valued for tax and regulatory purposes these gaps tend to favour foreign based multinational groups, putting Australian based multinationals at a competitive disadvantage and eroding Australia's tax base.

Having regard to these matters, there does appear to be scope to broaden Australia's company tax base. Based on the analysis in the foregoing Chapters the following areas of Australia's company tax system seem to warrant policy review:

- The safe harbour debt amounts in the thin capitalisation regime in Division 820 of the *Income Tax Assessment Act 1997*;
- The conduit financing provisions in section 25-90 of the *Income Tax Assessment Act 1997*;
- The asset valuation rules in Division 705 of the *Income Tax Assessment Act 1997* relating to tax consolidation;
- The exclusion of domestic dealings from the operation of the arm's length principle and the impact that may have on the integrity of the tax consolidation regime; and
- The immediate and accelerated write offs for large businesses provided by Division 40 of the *Income Tax Assessment Act 1997* relative to accounting amortisation and depreciation.

A common thread throughout Chapters 2, 3, 4, 6, 10 and 11, and alluded to in Chapter 9, is that tax administration plays a vital role in the performance of Australia's company tax system. The ATO has a unique vantage point across the whole population of 1,400 major economic groups and plays a vital role in assuring their compliance. It is in a unique position to see how well the company tax base is performing, both in terms of the practical application

and coherence of its constituent legislative rules and in terms of taxpayer compliance. Arguably the ATO's strategic role is, as with other heads of revenue and taxpayer demographics, to optimise the company tax base (as defined by the company tax provisions) in relation to compliance by multinational groups and to make recommendations for areas of improvement.

Chapter 11 proposes four interconnected sets of strategic questions for evaluating the ATO's administration of compliance by multinational groups. These questions focus on: the ATO's understanding of its operating environment; a factually based evaluation of how the company tax regime is performing; the strategic focus and operational effectiveness of ATO compliance programs; and, matters going to the nature of the relationship it needs with the large business sector. That Chapter also suggests a strategic framework and an administrative approach to optimising the tax base and identifying areas for improvement.

An important part of the company tax system performance evaluation depends on a rigorous bottom up methodology for estimating the tax gap. By basing the estimation process on a rigorous risk assessment across each of the 1,400 major economic groups, the resultant tax gap measure becomes far more useful and realistic because the components of the aggregate risk are connected to actual cases and objective measures of profit.

Notwithstanding that the results of its compliance program are not insignificant, there is potential for the ATO to enhance its operational effectiveness and speed up the collection of tax underpayments. It is essential that the ATO be able to effectively cover all of the 1,400 major economic groups. Effectiveness in this sense means that the ATO identify and address all material risks across that whole population. This seems to be presenting major challenges in relation to cases falling below the top 100 major economic groups, the ATO intending to extend its "justified trust program" coverage to the largest 1,000 public and multinational groups on a four-year cycle. This still leaves 300 major economic groups unaccounted for out of the total 1,400 population. While the ATO is clearly making efforts to enhance the data it collects from the 1,400 groups and improve its risk diagnostics – both of which should assist in identifying material risks – the real difficulty will be in resourcing any necessary follow up action and ensuring that risk assessment analytics and case investigations are conducted with the necessary technical expertise. That said, the proposed approaches may enable the ATO to gain some increased efficiency in the allocation of its non-committed resources in the sense that the cases involving the highest levels of risk may be more readily identifiable and be able to be allocated for follow up as soon as resources become available.

As discussed in Chapter 11, based on the analysis of the published information and the contra indications in relation to large business tax compliance, the ATO's expressed confidence in the tax compliance of large corporate groups appears somewhat premature. This is not to say that multinational groups will invariably have poor compliance records. It is simply an observation that there is insufficient detail to express overall conclusions on the extent of good and bad compliance and the trend in company tax collections warrants further detailed examination, particularly in relation to the 1,300 major economic groups below the top 100.

Given all the contra indications, the ATO estimate of the corporate tax gap for 2014-15 of $2.5 billion appears conservative. When consideration is given to the various sources of Commonwealth revenue, the contributions from Australia's company tax base are declining in absolute and relative terms, individuals and consumption carrying an increasing share, as shown in Tables 1 and 2. This suggests that the trend in company tax collections may be

somewhat anomalous given the continuous growth in the Australian economy and the increase in dividend pay-outs and share buy-backs. The construction of a basket of measures to establish and monitor trends in effective tax rates at the case level and compare reported profit performance to objective market-based rates of return would be very helpful.

The $2.5 billion tax gap estimate relates to a single prior income year. Even on the basis of the ATO's conservative estimates the total pool of unaddressed company tax risk is a multiple of that amount, as seen in Tables 7 and 8, which do not contain tax gap estimates for the 2015-16 and 2016-17 income years.

As demonstrated in Chapter 11, the broader statistical analyses presented in support the ATO's view of the level of compliance carry significant risks of endogeneity (the "garbage in garbage out" effect in analytics produced by the use of data sets that are self-confirming because objective measures of profit needed to adjust anomalies are missing from the analysis). However, much of the statistical analysis published by the ATO is broadly contextual and its usefulness is debateable, especially given the ATO's own serious and well founded reservations about top-down methodologies. In the final analysis, the reliability of the $2.5 billion estimate of the corporate tax gap hangs on the quality of the data and methodology used to derive it. Observations in that regard have already been included in Chapter 11. In fairness, it needs to be acknowledged that the ATO has to start somewhere, on the basis of the best available information; but it should also be acknowledged that the estimate is not as robust or useful as one that is derived from a rigorous examination and ongoing monitoring of the full population of the 1,400 major economic groups.

On the basis of what the ATO is currently able to achieve in terms of coverage and compliance program outcomes, it does not appear that on existing resource levels the ATO can make significant inroads into the total pool of company tax risk presented by the 1,300 second tier groups. The four year cycle planned in respect of the extension of its "justified trust program" does not appear to be an acceptable timeframe.

In overall terms, there is scope for the ATO to improve its strategic focus on the 1,400 major economic groups and improve its intelligence on strategic tax issues as they are currently unfolding in that patch. It needs to spell out in measurable terms what it sees as constituting success in terms of optimising the company tax base and making recommendations for improvements. It needs to monitor the patterns and trends in company tax collections, effective tax rates and tax technical issues and develop a deeper understanding of the structural drivers and dynamics producing those patterns and trends. In this way it will be clearer to the ATO and its key stakeholders where the ATO is at and what progress it is making in that taxpayer demographic in terms of optimising the tax base and suggesting improvements that will have material impacts.

In parallel with this, a sharper focus on operational efficiency and effectiveness should produce significant improvements in a fairly short space of time, given that many of the basic building blocks seem to be taking shape.

The concern is that unless these key strategic and operational shifts are made and resourcing is increased to build on the ATO's current efforts the pool of tax risk in relation to the major 1,400 economic groups is likely to grow.

From the analysis in Chapters 8, 9 and 11 a number of data adequacy and data integrity issues arise in relation to the ATO's ability to more efficiently identify and quantify tax risk. The ATO is in the process of increasing its sources of data for its systematic risk assessment processes. That exercise would be enhanced by the development of a high level framework where the necessary elements of data set design and analytics are addressed to ensure that any present information and analytical gaps that would compromise its work on risk assessment and tax gap measurement are addressed. Particular regard should be had to the mapping of global economic value chains and the development of objective open market based measures of profit (or reasonable surrogates) that would be reliable at the case level.

The analysis in Chapters 6 and 10 of litigation involving Australia's transfer pricing rules gives confidence that the law is robust. However, there is an ongoing need to ensure that the ATO can develop the business narrative about the real world of the taxpayer and how its business really operates. To complement this the ATO needs to also develop the narrative of what those provisions are trying to achieve through the different iterations of statutory mechanisms. The law will drive the evidentiary requirements, including the kind of expert testimony that is likely to be probative, and the framing of the Commissioner's arguments. Together these narratives will better support the application of the transfer pricing rules.

There are key areas of business activity that deserve renewed focus. These include corporate financing and inbound marketing and distribution. At a more general level, cases where a multinational group has a significant economic presence in Australia, is reporting relatively poor economic performance and has high values of cross-border related party dealings warrant scrutiny, especially where the offshore party is in a low or no tax jurisdiction. More detailed analysis is included in Chapters 2[174], 3[175], 4[176], 6[177] and 10[178].

There is a delicate balance that the ATO needs to strike in its relations with large businesses. The ATO, as the statutory regulator, needs to maintain sufficient distance to dispassionately and professionally go about its job of optimising the company tax base.

The use of the systemic analysis framework described in Chapter 2 has been demonstrated to be effective in distinguishing between economic, tax policy and tax avoidance drivers and impacts in relation to Australia's global positioning, the current performance of the Australian economy, the operation of Australia's company tax regime and in the application of particular provisions to the facts and circumstances of particular cases. It has also been shown to significantly enhance the evaluation of ATO effectiveness.

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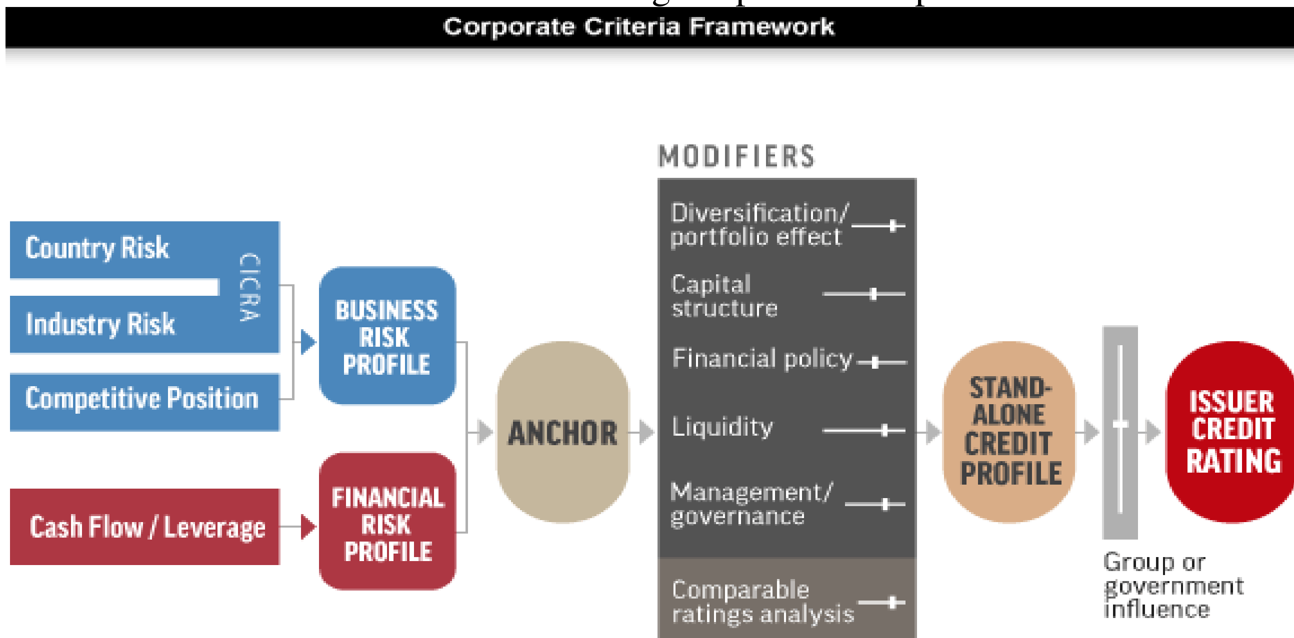
[174] See the sections entitled, *The dynamic nature of systemic analysis and the tax significance of intra-group dealings*, and *Understanding economic value chains of multinational groups and how tax impacts*.
[175] See the sections entitled, *Multinational groups have enormous flexibility in structuring their global operations*, and *The effectiveness of profit shifting strategies is determined by their economic substance*.
[176] See the section entitled, *Misalignment between liability to Australian tax and economic value created by Australia*.
[177] See the sections entitled, *Business structures and tax structures* and *Financial strategy and tax issues related to the funding of group subsidiaries*.
[178] See the section entitled, *The competitive market system of marketing and distribution companies*.

APPENDIX 1

Standard and Poor's Frameworks for Rating Corporate Groups and Subsidiaries

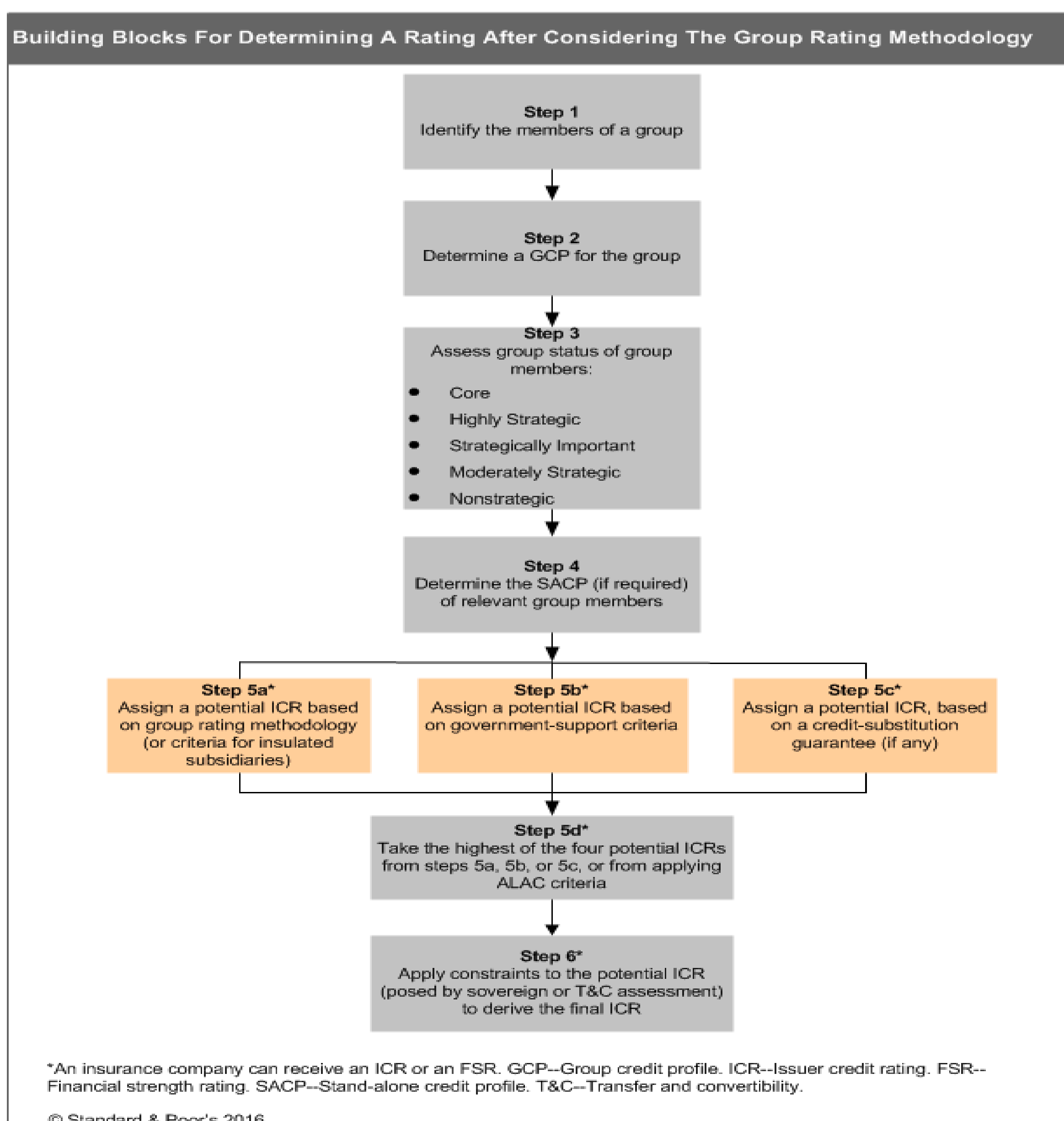


The S&P methodology further explains the framework in the following terms:

> "4. The business risk profile comprises the risk and return potential for a company in the markets in which it participates, the competitive climate within those markets (its industry risk), the country risks within those markets, and the competitive advantages and disadvantages the company has within those markets (its competitive position). The business risk profile affects the amount of financial risk that a company can bear at a given [Stand Alone Credit Profile] SACP level and constitutes the foundation for a company's expected economic success. We combine our assessments of industry risk, country risk, and competitive position to determine the assessment for a corporation's business risk profile.
>
> 5. The financial risk profile is the outcome of decisions that management makes in the context of its business risk profile and its financial risk tolerances. This includes decisions about the manner in which management seeks funding for the company and how it constructs its balance sheet. It also reflects the relationship of the cash flows the organization can achieve, given its business risk profile, to the company's financial obligations. The criteria use cash flow/leverage analysis to determine a corporate issuer's financial risk profile assessment.
>
> 6. We then combine an issuer's business risk profile assessment and its financial risk profile assessment to determine its anchor (see Table 3). Additional rating factors can modify the anchor. These are: diversification/portfolio effect, capital structure,

> financial policy, liquidity, and management and governance. Comparable ratings analysis is the last analytical factor under the criteria to determine the final SACP on a company.
>
> 7. These criteria are complemented by industry-specific criteria called Key Credit Factors (KCFs). The KCFs describe the industry risk assessments associated with each sector and may identify sector-specific criteria that supersede certain sections of these criteria. As an example, the liquidity criteria state that the relevant KCF article may specify different standards than those stated within the liquidity criteria to evaluate companies that are part of exceptionally stable or volatile industries. The KCFs may also define sector-specific criteria for one or more of the factors in the analysis. For example, the analysis of a regulated utility's competitive position is different from the methodology to evaluate the competitive position of an industrial company. The regulated utility KCF will describe the criteria we use to evaluate those companies' competitive positions (see "Key Credit Factors For The Regulated Utility Industry," published Nov. 19, 2013)".

S&P also published framework for rating corporate groups. Special considerations are included for rating financial services groups (banks, other financial institutions and insurance companies)



The framework is explained in the following terms:

> "11. The group rating methodology explains how our assessment of likely extraordinary group support (or conversely, negative group intervention) factors into the [Issuer Credit Rating] ICR on an entity that is a member of a group.
>
> 12. The methodology consists of six steps (see chart 1):
>
> Identifying the group's members;
> Determining a group credit profile (GCP);
> Assessing the status of an entity within the group and the resulting likelihood of group support;
> Assessing a stand-alone credit profile (SACP) for an entity if required;
> Combining the SACP and support conclusions to determine a potential ICR for a group entity, by notching up or down from the SACP or GCP; and
> Applying constraints if any to the potential ICR, depending on the relevant sovereign rating and/or transfer and convertibility (T&C) risk assessments.

13. The criteria define five categories of group status: "core," "highly strategic," "strategically important," "moderately strategic," and "nonstrategic." These categories indicate our view of the likelihood that an entity will receive support from the group and determine the potential long-term ICR, with reference to the GCP and SACP (see table 1)".

Table 1

Summary Of Associating An Entity's Group Status With A Potential Long-Term ICR		
Group status	**Brief definition**	**Potential long-term ICR***
Core	Integral to the group's current identity and future strategy. The rest of the group is likely to support these entities under any foreseeable circumstances. (see ¶¶54-55)	Generally at GCP (see ¶74)§
Highly strategic	Almost integral to the group's current identity and future strategy. The rest of the group is likely to support these subsidiaries under almost all foreseeable circumstances. (see ¶57)	Generally one notch below GCP (but see ¶74)§
Strategically important	Less integral to the group than highly strategic subsidiaries. The rest of the group is likely to provide additional liquidity, capital, or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support. (see ¶59)	Generally three notches above SACP (but see ¶74)§
Moderately strategic	Not important enough to warrant additional liquidity, capital, or risk transfer support from the rest of the group in some foreseeable circumstances. Nevertheless, there is potential for some support from the group. (see ¶60)	Generally one notch above SACP (but see ¶74)§
Nonstrategic	No strategic importance to the group. These subsidiaries could be sold in the near to medium term. (see ¶61)	Generally at SACP (but see ¶74)§
***Paragraph 28 prevails when the GCP is 'ccc+' or lower. §The potential issuer credit rating (ICR) is subject to sovereign rating constraints (see ¶77) and the government support criteria (see ¶27). An insurance company may receive an ICR and/or an FSR (financial strength rating). GCP--Group credit profile (see ¶33). SACP--Stand-alone credit profile (see also the Glossary in Appendix A).**		

APPENDIX 2

Proof Committee Hansard for 24 February 2017 Pages 13-14 and 16-17, House of Representatives Standing Committee on Economics, Reserve Bank of Australia annual report 2016, evidence given by Dr Lowe, Governor of the Reserve Bank of Australia and referred to in Footnote 61:

> Dr Lowe **:…..** I have been saying this for some years now: with interest rates so low right around the world, including here, we have been trying to induce households to spend money through lower interest rates. It would be a better strategy to create new assets rather than current consumption. The best new assets to create in our country at the moment are infrastructure assets, particularly in transportation networks….
> …I could again make a kind of general point about urban transportation. The population is growing quickly, our cities are crowded, it is hard for people to get around and the lack of supply of well-located land is pushing up housing prices. I think in many respects investment in urban transport infrastructure in the major cities is a first-order gain. It increases demand, takes the pressure off ultra-low interest rates and increases the productive capacity of the economy as people can move around. Also, it takes pressure off housing prices. It is probably the best housing affordability policy—investment in transportation infrastructure. That is the analytical point.
> …..I have long thought that there must be quite a few investment projects in urban transport where there would be a strong business case for society, where the return could be greater than—well, the government bond rate at the moment is, what, 2.8 per cent? You can borrow for 10 years for 2.8 per cent, so can we find projects that generate that? Probably yes, and it does not need to be borrowed by the government. My last point—maybe it is a barrow!—is that the last thing that government can do that the private sector cannot is urban planning, marshalling resources to construct a viable business case. That is something, particularly on transport, that government can uniquely do. It does not necessarily need to be the government money, but the government needs to bring planning capacity. You see how that has worked in New South Wales. It has made a first-order difference to the economy here, and ultimately it will make people's lives better as well. …….(Pages 13-14)
>
> Mr KEOGH: I want to turn to corporate tax. We have had a long discussion about competitiveness. In the economic forum dinner speech that you gave, Governor, you did talk about this a little bit. You followed that on from a discussion of the increasing net government debt and the increasing demands that are being placed on government expenditure and the need to find a balance between recurrent spending and fiscal revenue. If there is a desire, for competitiveness reasons, to cut the corporate tax rate, that suggests that government also has to do something else—either increase taxes or reduce expenditure.
>
> Dr Lowe: As I said before, there are multiple objectives here, and you need to be able to finance current expenditure with revenue. Some people would argue that the extra investment you got would create extra growth in the economy and generate revenue. But I am not a tax expert so I cannot say whether that argument is valid or not.

Mr KEOGH: Looking at that as an economics issue, are there any studies of any examples around the world where a country has made a call to cut corporate tax rates and has actually shown a dividend of tax revenue growth?

Dr Lowe: I am not expert in this area so I have not read the literature here. I think that the best way of dealing with the revenue problem is to get growth in the economy and that would generate, over time, tax revenue. So rather than saying, 'We've got a given amount of growth, let's play around with the tax rates to try and get the best amount of revenue,' I think probably the better focus is, 'What can we do to encourage growth in the economy?' because that will, in the end, generate the tax revenue we need to pay for all the things that the Australian public want from their government.

Mr KEOGH: So in a context where, I think, the Treasury modelling had 10 years after 10 years after the final tax cut comes in and you get 0.1 per cent growth, that is not really creating—

Dr Lowe: I have not read that study. This is the kind of issue that you no doubt confront all the time, 'What do we do to encourage growth in the economy?' because that is the best way of financing government expenditure, rather than playing around with tax rates and—

Mr KEOGH: So if I ask that question in reverse: what you are not saying—and maybe because you are not in a position to say it—is that that cut in corporate tax rates will necessarily result in an instant growth in revenue or growth in the economy?

Dr Lowe: Correct, I would not imagine it would happen the next day. But over time, we need to make sure that there is a climate for private business investment in the country to generate the capital stock that is going to underpin our wealth. And the tax arrangements are one of the factors that play into that. There are other factors as well. I know it is a highly contested political issue, so I am trying to make the analytical point that the international tax competition is out there and the parliament has to decide whether to respond or not. But if we do not respond there are consequences, but if you do respond there are consequences as well. (Pages 16-17)

APPENDIX 3

The issue of casualization and underemployment referenced in Footnote 63 were discussed in the RBA appearance on 24 February 2017 before the House of Representatives Standing Committee on Economics. Pages 14 and 15 of the Hansard reporting [Proof Copy] include the following exchanges:

> **Mr KEOGH:** It is an interesting issue you raise which is the trend towards part-time employment. You talk about consumption needing security. There seems to be a trend not just towards part-time employment but underemployment as well. So, yes, more people have jobs but they are either employed less than they would like to be employed or in more tentative employment. So it is casualised or shiftwork or whatever else. When we talk about a 5¾ unemployment rate, putting aside the mining boom, being a good rate, it is not 5¾ full-time employment; it is 5¾ of very part-time or casualised employment. It is not quite the same; you are not comparing apples with apples there—are you?
> Dr Lowe **:** We have done quite a lot of work on underemployment and of how the trends in underemployment differ or do not differ from the trends in the unemployment rate. If I could ask Luci to speak on that.
>
> Dr Ellis **:** We published a box in the last *Statement on monetary policy* on this very issue, and the team have done quite a lot of work on this. What we found is, firstly, that the people who are unemployed basically have the same employment desires as the division between full-time and part-time employment in employment. I am struggling to remember the exact fraction, but the share of people who are unemployed who want a full-time job is roughly the same share as the share of full-time employment. Of the people who have work but would like to work more hours, obviously most of those are part time, by definition. There is a very small fraction, which has not risen that much, of people who are normally full-time workers but are working part time for economic reasons, and they are included in the underemployment statistics. But the majority of them in the underemployment statistics are part-timers who would like to work more hours.
> There are a couple of interesting things about that group. Firstly, the primary driver of the increase in that underemployment figure is simply that there are more part-time workers now than a couple of decades ago and so, for a reasonably constant fraction of part-time workers who would like to work more, that fraction goes up as a share of the total labour force. Another interesting fact is that the amount of extra hours they would like to work is roughly 15 hours, and that has been constant for a very long time. They essentially want two more days of work. So it is someone who works one day who wants three or someone who works two days who wants four. Some part-time workers would actually prefer to work full time, and that is absolutely true. Another important fact about the underemployed is that, although many of them would like to work more hours, only about half of them are actually doing anything about it, including asking their current employer for more shifts or for more work. When we looked into this in greater detail, noting that the unemployed are roughly two-thirds people who want full-time work, whereas the people who are underemployed are people who want roughly two days of work, the amount of actual spare capacity that they imply is less—one underemployed worker implies less spare capacity than one unemployed worker. More to the point, also only about half of the

people who are recorded as underemployed part-time workers are actually doing anything about it and therefore in some sense meet the same criterion as someone who is unemployed, who has to be doing something actively, seeking a job, in order to be recorded as unemployed.

What these figures do not, however, cover is the security of the employment people have. People may have a full-time job or a part-time job where they are perfectly happy with the number of hours but, as you mentioned, because they are on casual rates or they are on a short-term contract, they may find that is not so secure. The numbers that we have available on underemployment do not address that point.

Mr KEOGH: But that issue would affect willingness to consume. Would that be right?

Dr Ellis **:** I think that would be right but I think even more so it would affect people's willingness to take on obligations like debt. So in some sense that is also a consideration. People can spend what they earn in that week—

Mr KEOGH: They might save more but they are also not going to buy a house; they will keep renting.

Dr Ellis **:** They will not be saving, because they are living day to day. So they are not saving to buy a house, but also they may not feel in a position to take on a fixed dollar debt obligation like a mortgage. I think that is the way to frame the issue about casualisation.

APPENDIX 4

The issue of the connection between company tax rate settings and foreign investment referenced in Footnote 85 was discussed by the House of Representatives Standing Committee on Economics with RBA representatives at its hearing on 24 February 2017 (Pages 6 and 11-13 of the Proof Committee Hansard). Those discussions reflect the RBA view that taxation is one of several factors impacting on foreign investment:

> **CHAIR (Mr Coleman):** I guess it is fairly self-evident that a less-competitive corporate tax environment is less-desirable for corporate investment than a more-favourable tax environment.
>
> Dr Lowe **:** For internationally mobile capital I think that is true. Australia has other advantages, and the tax system is supposed to deal with issues other than just attracting investment—there is equity and fairness and other considerations. But if you are just approaching this from the perspective of how we attract investment in the creation of new assets in Australia, the fact that there is international tax competition does have a bearing on that. We might not like it—as I said before, we are better off not competing on tax rates. That is one reason we do not have different income tax rates and corporate tax rates across the country—it is because the states would compete on those things. We cannot do that at the international level but it is up to you, the parliament, as to whether or not we ignore that. (Page 6 of the Proof Committee Hansard)
>
> **Mr BUCHHOLZ:** Thank you, Governor, for your opening remarks. With your indulgence, I would like to direct my line of questioning to Dr Ellis. Dr Ellis, I want to pick up on the governor's comments around the corporate tax rate globally. In his response, he mentioned that with the fiscal settings from government we can either respond in that space or not respond as countries that we would compete with in that space aggressively seek to drop their corporate tax rate. Do you have an opinion on what the opportunity costs are for us as a country? What will it look like for us if we as a government do not move in that space and choose not to respond?
>
> Dr Ellis **:** I have the same opinion as the governor.
>
> **Mr BUCHHOLZ:** They will you bring you back next week! Let's tease it out. Let's see what it looks like if we do not do anything. We can respond. The governor also has an opinion on that. He is on the record with some of the biggest global investors in the world when they arrived here for the A50 as saying that we need to do something. In the event that we do not, however, there are real threats to our country. Do you have an opinion as to what they look like?
>
> Dr Ellis **:** I would say that the analytical framework that the governor set out is the right one to lay these things out in. If you are a primarily locally oriented corporate entity, you have dividend imputation and it is more or less irrelevant what the corporate tax rate is from the perspective of people who wish to

invest in your firm. That is also true for the very large pool of superannuation savings that we have in this country.

Where it does matter is with foreign investors deciding whether to invest in Australia versus elsewhere. What we then need to think about is: what is the nature of the investment that we are getting from foreign investors and how much of it is foreign direct investment, which builds new things versus, say, purchasing of existing securities or purchasing of existing assets? The framework that I would bring to this is to think about how much difference it would make to a foreign investor wishing to do foreign direct investment. That is the bit that could, if it were put off, potentially be more damaging to an economy, but investors think about more than just differential tax rates when they are making foreign direct investment decisions.

Mr BUCHHOLZ: The other side of that would be if we are talking about new investment coming to the country. Do we have a sense of how much of that investment, that already exists in the country, might look to migrate away from here in pursuing more aggressive tax rates?

Dr Ellis **:** The answer to that is that foreign direct investment is primarily focused on long-term issues. The business case would still be there. Also, you have to remember that many multinational corporations do have the capacity to decide where the revenue is recognised. That is why there are so many—

Mr BUCHHOLZ: Through transfer of pricing?

Dr Ellis **:** Through transfer-pricing. Again, to the extent that there are transfer pricing alternatives to where you locate your income, it is not clear to me that that then changes people's decisions about whether Australia is a good place to have some business. It might change which government gets the revenue.

Mr BUCHHOLZ: If, as a government, there was a choice to respond and to become competitive in that space globally—speaking directly to the transfer-pricing issue—would you suggest that those numbers would increase with our level of competitiveness or decrease?

Dr Ellis **:** As I said last time we met, I am not a tax expert. You are now asking me about a different part of the tax system. I would have to have a longer think about it to make sure there are not other factors that are impinging on that. To the extent that transfer pricing is not impinged upon by other mechanisms within the broader tax system, you could imagine that it would become increasingly attractive for multinational firms to seek to locate their revenue recognition in lower tax havens. But there are already very low tax jurisdictions where they can do that, and we still see investment happening in the country. I cannot imagine a scenario where a few more countries moving in this direction results in the entirety of that activity moving outside Australia's borders.

Dr Lowe **:** You may be aware of the work that has been going on globally on the base erosion of profit-shifting called BEPS. At many of the G20 meetings

I go to, a lot of time is spent on this trying to come up with some set of arrangements that limit the ability of multinational corporations to shift profits to minimise their tax inappropriately.

Mr BUCHHOLZ: So the two arms are not directly connected, but there is a line of similarity between companies chasing a more aggressive rate in their corporate tax rate?

Dr Lowe **:** Yes. Some countries, for better or worse, have decided to either have lower corporate tax rates or lax enforcement of the existing legislation as a way of attracting more foreign investment. As Luci said, the issue for us is not so much attracting foreign investment to buy the existing assets. That is useful, in a way. Foreign investment comes in and buys existing assets and runs them more effectively. That does not create that much wealth for the country. The other aspect is foreign investors are coming in and creating new assets, new jobs and new growth. That capital is very mobile.

As I said in response to Mr Coleman's question: Australia has lots of advantages, so firms come here for a lot of reasons, including the skilled workforce, the legal property rights and the wonderful places that we have to live, but tax is a consideration. It is pretty clear that, if you are uncompetitive in the tax rates, you will probably get a few less dollars of capital formation by foreign firms in the country. Whether that is enough to get you to change the corporate tax rate I do not know because there are other considerations as well, but I think, as an analytical point, in the end, if you have an uncompetitive tax rate, you do get less capital formation by foreign firms in your country.

Mr BUCHHOLZ: So if we had a corporate tax rate similar to where the transfer pricing energy was being invested—what is Singapore's rate? Ten to 15? It can vary, I suppose. It is a floating one. Assuming it is 15 per cent, if our tax rate was at 15 per cent at some period of time into the future would transfer pricing still have the same attractiveness for Australian companies?

Dr Lowe **:** Again, I think analytically that means there is less incentive to shift profits around if there is less difference in the corporate tax rates. But there are other perspectives on this issue as well. The tax system is not just about creating the maximum amount of capital formation in the country, although that is a perfectly legitimate objective. But there are other objectives here that the parliament cares about, like the need to raise revenue from some source. There are enough demands for government to do stuff, but you have to get the revenue from somewhere. The issue of fairness is kind of imposed. But I think if you are approaching it just from the prism of capital formation is it pretty clear you need to be competitive. (Pages 11 to 13 of the Proof Committee Hansard)