

Transfer Pricing e-Alert

6 JULY 2018

Transfer Pricing and Interest from Intercompany Loans

Cross-border intercompany loans have been a staple for large multinational corporations. For those that have a presence in Malaysia, the Inland Revenue Board (**IRB**)'s recent crackdowns on transfer pricing certainly give cause for concern. Similarly, Malaysia's home-grown companies are now no stranger to cross-border intercompany loans. In line with rapid globalisation over the past few decades, most of these companies have set up operations or expanded beyond the region and are, therefore, in the thick of related-party borrowings.

Although there is currently no case law in Malaysia concerning transfer pricing on intercompany loans, the Australian Courts shed light on this matter last year. The Full Federal Court handed down its landmark decision in *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation* [2017] FCAFC 62, upholding the Australian Taxation Office (**ATO**)'s A\$340 million tax assessments on Chevron Australia Holdings Pty Ltd (**CAHPL**). The case centred on a dispute on cross-border related party financing, in particular, the deduction of interest expenses by CAHPL in relation to a loan granted by its American subsidiary, Chevron Texaco Funding Corporation (**CFC**).

Facts

CAHPL was the Australian holding company of the Chevron group of companies. Its ultimate US parent company was Chevron Corporation (**CVX**). Under a credit facility agreement between CAHPL and CFC, CAHPL had borrowed US\$2.45 billion at an interest rate of approximately 9% from CFC. CFC had raised the money which it lent to CAHPL by issuing commercial papers in the US at an interest rate of 1.2%. CAHPL did not provide security for the loan, and CFC did not provide a loan guarantee. There were also no financial or operational covenants in the credit facility agreement that would bind CAHPL to conduct its business or to behave in any particular way.

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From 2004 to 2008, CAHPL had claimed tax deductions in Australia for the interest it paid to CFC in relation to the loan. The interest as income in the hands of CFC was not taxable in the US. In addition, CAHPL received substantial dividends from CFC that were not taxable pursuant to Section 23AJ of the Australian Income Tax Assessment Act 1936 (**ITAA 1936**). In 2010 and 2012, the ATO raised amended assessments for the said years on the basis that the interest paid by CAHPL to CFC was greater than it would have been under an arm's length dealing between independent parties.

Decision

The three Federal Court judges unanimously agreed with the initial trial judge in upholding the ATO's assessments. While the judgment of the Court covered a variety of legal and procedural issues, the substantive discussion on arm's length consideration and transfer pricing mainly revolved around the interpretation and application of the then Section 136AD(3) of the ITTA 1936. The section provided that the arm's length consideration in respect of an acquisition shall be deemed to be the consideration given or agreed to be given by the taxpayer where:

- (a) a taxpayer has acquired property under an international agreement;
- (b) the Commissioner of Taxation is satisfied that the parties to the agreement were not dealing at arm's length with each other in relation to the acquisition; and
- (c) the taxpayer gave or agreed to give consideration and the amount of that consideration exceeded the arm's length consideration in respect of the acquisition.

Section 136AA(3) provided that a reference to the arm's length consideration 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.

The key takeaways from the decision in relation to whether the interest exceeded the arm's length consideration are as follows:

- In interpreting the meaning of the sections above, the Court emphasised that the sections were not to be approached in

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a rigid or inflexible way — it is important to recognise the fiscal and commercial context in which the provisions operate.

- In determining what is the arm's length consideration, the appropriate question is what is the consideration that CAHPL or a borrower in its position might reasonably be expected to have given/agreed to give to an independent lender if it had sought to borrow A\$2.5 billion for five years.
- The assumption of/hypothesis based on independence does not necessarily require the detachment of the taxpayer from the group which it inhabits or the elimination of all commercial and financial attributes of the taxpayer. In other words, the Court concluded that CAHPL cannot run an argument that the arm's length consideration in respect of the loan should be determined on the hypothesis that the taxpayer was not a member of the Chevron group, or as if it were an "orphan" wholly independent from the group to which it belongs.
- Instead, it was permissible to hypothesise, based on the evidence, that in an arm's length scenario, CVX as the parent company would have guaranteed the taxpayer's obligations to a lender:

"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."

The Court held that the interest rate on the loan from CFC to CAHPL was likely higher due to the fact that CAHPL did not give security or any operational and financial covenants. If the loan had been acquired under an agreement between independent parties dealing at arm's length with each other, CAHPL would have given security and operational and financial covenants and the interest rate, as a consequence, would have been significantly lower.

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Implications for Malaysia

In line with the intensifying global crackdown on corporate tax avoidance by multinationals, transfer pricing has similarly been at the forefront of the IRB's focus in 2018. According to the IRB, leakages from transfer pricing by certain corporations will be the priority for tax compliance this year (See <http://www.theedgemarkets.com/article/tax-collection-2017-815-onyear-says-irb>).

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Similar to Section 136AD(3) of the ITTA 1936, Section 140A(3) of the Malaysian Income Tax Act 1967 empowers the Director General of Inland Revenue (**DGIR**) to substitute the price in respect of a transaction to reflect an arm's length price for the transaction where the DGIR has reason to believe that any property or services is acquired or supplied at a price that is either less or greater than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length.

In light of this and the *Chevron* case, it may be prudent for multinational corporations in Malaysia to review their related party financing agreements with their Australian and overseas counterparts to ensure that they are consistent with internal company policies. As highlighted in the *Chevron* case, transfer pricing issues may arise if there is evidence to show that their related party financing is undertaken inconsistently with any external financing policies.

Please contact us at tax@lh-ag.com if you have any queries on transfer pricing matters.

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