Singapore Telecom Australia Investments Pty Ltd (“Singtel”)
v
Commissioner of Taxation

PROFESSOR KERRIE SADIQ, QUEENSLAND UNIVERSITY OF TECHNOLOGY, AUSTRALIA

AND

PROFESSOR RICK KREVER, UNIVERSITY OF WESTERN AUSTRALIA

THE UNIVERSITY OF WESTERN AUSTRALIA

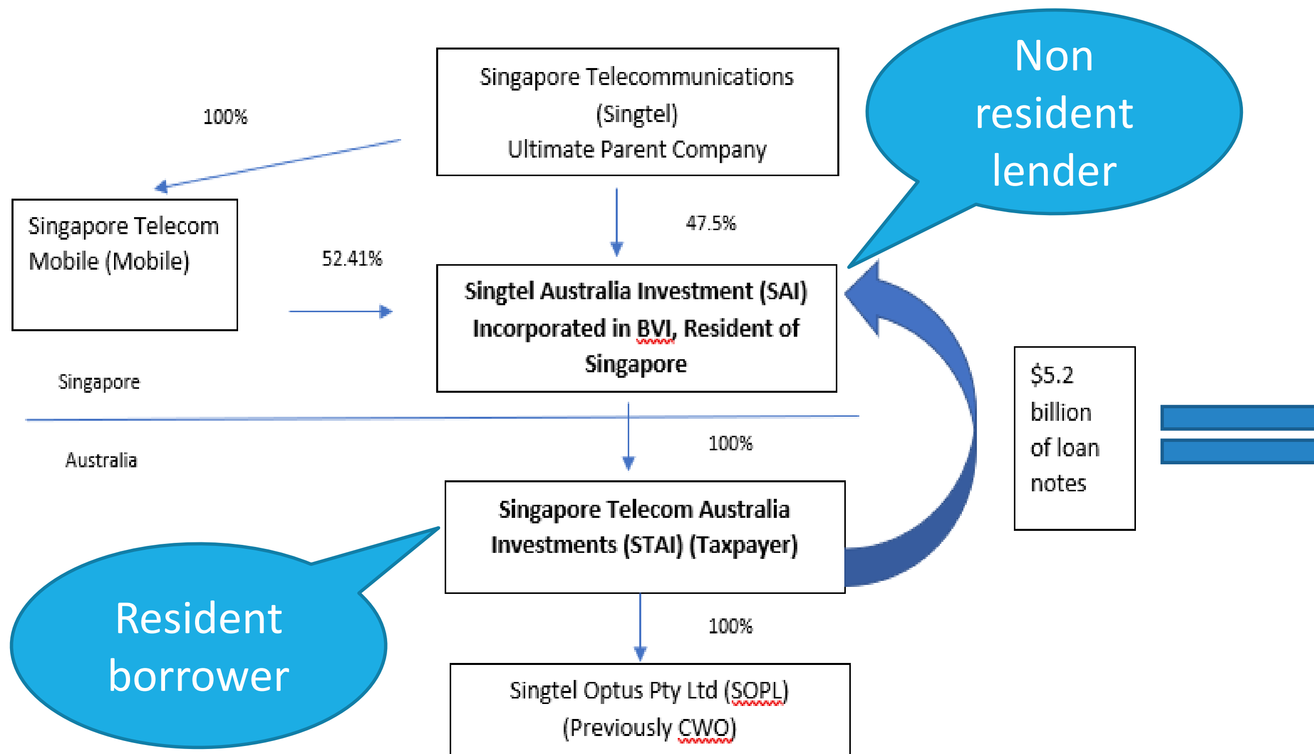
QUT Business School

International Transfer Pricing: The Issue in *Singtel*

When establishing an arm's length price for a transaction between two related parties, should the hypothetical alternative transactions treat both parties as if they were independent orphan companies, with no ties to controllers or a corporate group, or should it recognise their group membership when calculating the arm's length price for a substituted hypothetical transaction with a third party.

This is particularly important in the context of intra-group loans.

SingTel: The Facts



- 10 notes with a maximum period of ten years. Interest to be paid annually and principal repaid no later than 10 years after the issue
- The interest rate was the 1-year Bank Bill Swap Rate (the rate used to measure the cost for Australia's four major banks to issue short-term bank notes) plus 1% per annum,
- Interest rate was arguably in line with genuine arm's length costs.

SingTel: The Facts

- Renegotiated terms of the Loan Agreement
- interest payments deferred until specified financial performance benchmarks had been met (applied retrospectively)
- Interest rates were raised in two modifications to the contract
  - the first requiring a premium to be paid on redemption
  - the second replacing the floating interest rate to a much higher fixed rate.
- The taxpayer claimed the much higher interest rate and redemption premium did no more than reflect the time value of money for the deferred payment, while the Australian Taxation Office argued the rate exceeded the deferral value and should be regarded as a profit shifting arrangement.
- The Australia-Singapore tax treaty (Article 6) reflected the conventional OECD transfer pricing rule in Article 9 of the Model convention.
  - Australia-Singapore treaty provided authority for Australia to apply its domestic transfer pricing rules when determining the deduction to be allowed for the interest payments.

Australia's Transfer Pricing Laws: Background

- Transfer Pricing legislation dates back to 1921 however substantive cases only since the 1980s.
- 2012: OECD Transfer Pricing Guidelines formally incorporated into domestic legislation.
- Very few cases.
- Precedents (Common Law System):
  - Re Roche (2008) – sale of prescription drugs
  - SNF (2011) – minerals
  - Chevron (2017) – loan
  - Glencore (2020) – minerals

SingTel: The Dispute

- Australian Taxation Office concluded parties operating at arm's length from one another would not have agreed to amendments similar to those found in the taxpayer's modified loan agreement and accordingly reduced the allowed interest claim substantially.
- The taxpayer conceded from the outset that it was not operating at arm's length from its owner, the lender, a situation which could trigger the potential application of the Australian transfer pricing rules under the Australia-Singapore Treaty and Australian domestic law.
- The contentious fact situation was whether the unusual loan arrangements based on a modified contract and deferred interest payments reflected the cost of a hypothetical loan between parties operating at arm's length.
- The court separated the issue into two distinct issues:
  - whether the arrangements between the parties were comparable to those that might be found between independent enterprises dealing wholly independently with one another (a question the court labelled the "Conditions Issue") and
  - whether the deductions claimed by the taxpayer (and consequent profit calculated after deductions) were greater than those that would have been claimed if the parties had been unrelated arm's length enterprises (a question the court labelled the "Profits Issue").

SingTel: The Taxpayer's Case

- Conditions Issue: the relationship between the lender and taxpayer could be considered similar to an arm's length relationship in respect of the loan agreement because the transactions were not dissimilar from those found in ordinary loan arrangements between independent parties.

- Profits Issue: the total deferred interest redemption premium was the economic and commercial equivalent of the return an arm's length lender would have received under the original annual loan.

- The argument rested on two assumptions:
  - arm's length interest rates should be based on the prevailing rates used in the debt capital market where interest takes into account the risk factors published by independent credit rating agencies.
  - the taxpayer, had it been an independent company unrelated to the lender would not have had access to the parent company's debt guarantee and would, accordingly, have borne a higher interest charge.

SingTel: The Tax Office Case

- Conditions Issue: conceded financiers and borrowers sometimes agree to changed loan conditions in the course of the loan but argued that an independent financier would not have agreed to the taxpayer entering into a riskier loan agreement entailing a deferred interest obligation without a full guarantee by the parent.

- Profits Issue: Taxation Office expert witness disputed the contention that the interest rate charged was an arm’s length rate and the redemption premium was a fair compensation for the delayed payment.

Crucial difference

The taxpayer argued an arm's length calculation should assume both the taxpayer and the related party with which it dealt were completely independent entities unrelated group to which they belonged, the "orphan" interpretation of the arm's length standard.

The Australian Taxation Office, in contrast, argued that when calculating the arm's length interest that would be charged by an unrelated lender, it should be recognised that the taxpayer was part of a multinational group and assumed that the parent company or an affiliate would provide a full guarantee for the loan to reduce the group's borrowing cost through the taxpayer.

SingTel: The Court Decision

The court accepted the argument put forward by the Australian Taxation Office, agreeing that the taxpayer's parent company would have provided a guarantee for borrowings by its wholly owned subsidiary to reduce the borrowing cost even if the taxpayer were borrowing from a completely independent third party.

The starting point for the analysis, therefore, was that any hypothetical counterfactual arm's length loan that could be used to determine whether the transaction that took place artificially raised the interest expense would carry an interest rate reflecting a full guarantee by the taxpayer's parent corporation.

SingTel: Comments

- Why would the taxpayer have changed the loan arrangement so fundamentally if it could have achieved its deferral objective using an existing arm's length equivalent contract?
  - tax considerations, most likely related to the taxpayer's withholding tax obligations since under Australia's withholding tax rules, deferred interest did not attract withholding tax until it was paid while capitalized compounding interest would be subject to withholding tax annually.
- Unusual for the court to adopt an alternative hypothesis and still accept an assessment showing a greater adjustment than the hypothetical it has accepted.
- The Taxpayer has appealed the decision

SingTel: Conclusion

- The judgment was a very explicit rejection of the orphan theory of arm's length pricing that may have significant impact on future transfer pricing calculations under Article 9 of the OECD Model Convention and its equivalent in actual double tax agreements and comparable domestic laws.

- The hypothetical chosen by the court as the most commercially rational was the alternative with the lowest expense for the taxpayer.

- The decision provides useful guidance on how courts may interpret the commercially rational requirement in the OECD transfer pricing guidelines.

- When related parties devise an arrangement that has no counterpart in the open market, the transfer pricing will be tested against substitute hypothetical transactions that can provide the same goods or services to the taxpayer. A court is quite likely to conclude that the most commercially rationale is the one that delivers the goods or services at the lowest cost.