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Base Erosion by Intra-group Debt and BEPS Project Action 4's Best Practice Approach—A Case Study of Chevron

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Abstract

It is well known that many multinational enterprises use intra-group debts for tax avoidance purposes. Action 4 of the OECD's Base Erosion and Profit Shifting (BEPS) project represents a recent major contribution to the literature on the subject, providing important insights into the design features and issues of different forms of interest limitation regimes in practice. At the other side of the world, a recent major tax case and the Senate enquiry into corporate tax avoidance in Australia revealed detailed information about how Chevron used intra-group debts in its tax structures, which is very difficult, if not impossible, to discern from its financial statements. It provides a timely case study of how intra-group debts are used in practice, setting the stage for an evaluation of Action 4's recommendations. The aim of this article is twofold. First, it analyses two tax structures used by Chevron in Australia as a case study to highlight the key issues arising from intra-group debts. Secondly, using empirical data on Chevron, this article evaluates whether Action 4's recommendations are effective for addressing BEPS arising from intra-group debt.

1. Introduction

It is well known that many multinational enterprises (MNEs) use intra-group debts for tax avoidance purposes.[1] The popularity of this tax avoidance tool can be attributed to its simplicity, as described in the Final Report of Action 4 of the BEPS project (Final Report)[2]:

> "The use of third party and related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity."

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[1] For instance, a recent proposal for a European Council Directive against tax avoidance states that "Multinational groups often finance group entities in high-tax jurisdictions through debt and arrange that these companies pay back 'inflated' interest to subsidiaries resident in low-tax jurisdictions … Overall, the outcome is a reduced tax base for the multinational group as a whole": European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, Brussels, 28.1.2016 COM(2016) 26 final, 2016/0011 (CNS), 7.

[2] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (Paris: OECD Publishing, 2015), 5, para.1.

Intra-group debts are particularly simple to use, as they do not involve third parties and "can be created with the wave of a pen or keystroke".[3] They often do not require any movement of assets, functions or personnel within a corporate group, or any major change of its operations. Furthermore, intra-group debts provide significant flexibility for manipulations, as explained in a paper released by the United Nations[4]:

> "Related party loans are not subject to market discipline, in the way that a debt from an unrelated party would be. The amount of the loan may be in excess of the amount that a third-party would be willing to lend … there can be transfer pricing concerns with respect to the rate of interest paid and other terms of the loan."

The popularity of using intra-group debts as a tax avoidance tool is further enhanced by the fact that in general they are not recognised under accounting standards and therefore do not affect consolidated financial statements of MNEs. It is not surprising that the OECD describes the BEPS risks arising from intra-group debt as the "*main* tax policy concerns surrounding interest deductions" (emphasis added).[5]

There is huge literature on the issues arising from interest deduction on intra-group debts.[6] The OECD's work on the subject in the BEPS project—in particular, Action 4 which focuses on "limiting base erosion involving interest deductions and other financial payments"—represents a recent major contribution to the literature, providing important insights into the issues and design features of different forms of interest limitation regimes in practice.

At the other side of the world, a recent major tax case and the Senate enquiry into corporate tax avoidance in Australia revealed detailed information about how Chevron used intra-group debts in its tax structures, which is very difficult, if not impossible, to discern from its financial statements. It provides a timely case study of how intra-group debts are used in practice, setting the stage for an evaluation of Action 4's best practice approach.

The aim of this article is twofold. First, it analyses two tax structures used by Chevron in Australia as a case study to highlight the key issues arising from intra-group debts. The first structure, which was in place from 2004 to 2009, was the subject of a recent major tax case in

[3] C. Burnett, "Interest Deductions and Multinational Enterprises: Goldilocks and the Brave New World" (2015) 69(6/7) *Bulletin for International Taxation* 326 (June/July), 326.

[4] United Nations, *Limiting Interest Deductions* (2014), paper prepared by P. Barnes in *Papers on Selected Topics in Protecting the Tax Base of Developing Countries*, 22. The BEPS risk arising from related party debts is also recognised by the OECD in the discussion of an option to exclude certain public-benefit projects from the best practice approach in the Final Report. In particular, the OECD states clearly that such an exclusion should apply, among other things, only to "third party loans": Final Report, above fn.2, para.64.

[5] OECD, *Public Discussion Draft—BEPS Action 4: Interest Deductions and Other Financial Payments* (18 December 2014–6 February 2015) (Discussion Draft), available at: *http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf* [Accessed 20 January 2017], para.3. The OECD received over 100 submissions on the Discussion Draft (available at *http://www.oecd.org/ctp/aggressive/public-comments-action-4-interest-deductions-other-financial-payments.htm* [Accessed 20 January 2017]), and held a public consultation meeting on 17 February 2015. The video recording of the consultation meeting is available at: *http://www.oecd.org/ctp/aggressive/public-consultation-action-4-interest-deductions-other-financial-payments.htm* [Accessed 20 January 2017].

[6] For example, see: IFA, *New tendencies in tax treatment of cross-border interest of corporations, Cahiers de droit fiscal international* (2008), Vol.93b, including the list of previous studies of the same issue at 17; and the citations in E. Traversa, "Interest Deductibility and the BEPS Action Plan: nihil novi sub sole?" [2013] BTR 607, fn.2.

Australia.[7] The second tax structure has been in place from 2010 and was revealed in the Senate enquiry into corporate tax avoidance in Australia.[8] Secondly, this article reviews the OECD's best practice approach recommended in the Final Report for Action 4, and, using Chevron as a case study, evaluates whether the recommendations are effective for addressing BEPS arising from intra-group debt.

The issues arising from interest deductions are highly complex and often involve different areas of the tax law. As this article focuses on the general design issues with respect to interest limitation regimes for anti-BEPS purposes, a few caveats are in order. First, detailed technical analysis of the current Australian thin capitalisation regime and the transfer pricing issues involved in the *Chevron* tax case are beyond the scope of this article.[9] Secondly, this article does not analyse in detail other Actions of the BEPS project which also address issues arising from intra-group debts, such as Action 2 on hybrid instruments and entities,[10] Action 3 on Controlled Foreign Company regimes[11] and Action 9 on transfer pricing issues[12] regarding risks and capital.[13] Thirdly, detailed discussion of issues arising from the interaction between the recommendations of Action 4 and the EU law as well as tax treaties is also beyond the scope of this article.[14]

[7] *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* (*Chevron*) [2015] FCA 1092 (available at: *http://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2015/2015fca1092* [Accessed 20 January 2017]).

[8] Documents of this enquiry are available at: *http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance* [Accessed 20 January 2017].

[9] For a good summary of the transfer pricing issues in *Chevron*, above fn.7, [2015] FCA 1092, see R. Vann and G. Cooper, "Transfer Pricing Money — the *Chevron* case" (2016) Sydney Law School Legal Studies Research Paper No.16/72, available at: *http://ssrn.com/abstract=2823220* [Accessed 20 January 2017]. See also: Greenwoods Herbert Smith Freehills, *Tax Brief: The Chevron transfer pricing case — the story so far* (5 November 2015), available at: *http://www.greenwoods.com.au/media/1721/new-tb-re-chevron-dated-5-november-2015.pdf* [Accessed 20 January 2017].

[10] The OECD recognises that even where a country adopts the best practice approach as recommended in the Final Report of Action 4, the risk of BEPS "posed by hybrid mismatch arrangements is reduced … [but] not eliminated … there may still be significant scope for an entity to claim interest deductions … where a hybrid financial instrument or hybrid entity is used to give rise to a double deduction or deduction/no inclusion outcome": OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2— 2015 Final Report* (Paris: OECD Publishing, 2015), para.317. Furthermore, hybrid mismatch arrangements can also be used to manipulate a group ratio rule: ibid. Therefore, the OECD recommends that "a country should implement all of the recommendations in [the Final Report on Action 2], alongside the best practice approach agreed under Action 4 … Rules to address hybrid mismatch arrangements should be applied … before the fixed ratio rule and group ratio rule": ibid. In other words, the OECD realised that significant BEPS risks arising from intra-group debt would not be addressed effectively unless there is wide-spread adoption of recommendations for Actions 2 and 4. This implies that these risks are unlikely to be removed entirely as some countries may not implement all these recommendations.

[11] OECD/G20 Base Erosion and Profit Shifting Project, *Designing Effective Controlled Foreign Company Rules, Action 3—2015 Final Report* (Paris: OECD Publishing, 2015).

[12] OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports* (Paris: OECD Publishing, 2015).

[13] For a discussion of the interactions between Action 4 and other Action items, see: Discussion Draft, above fn.5, Ch.XIV. Some commentators were doubtful whether there would be meaningful progress on the transfer pricing issues arising from interest deductions: Vann and Cooper, above fn.9, 15.

[14] For discussions of the relevant EU law issues in respect of Action 4, see: Discussion Draft, above fn.5, Annex 2; and S. Douma, "Limitations on Interest Deduction: an EU Law Perspective" [2015] BTR 364. For a discussion of the relevant tax treaty issues, see for example O. Marres, "Interest Deduction Limitations: When to Apply Articles 9 and 24(4) of the OECD Model" (2016) 56(1) *European Taxation* 2 (2 January). It should be noted that in July 2016, the European Commission adopted a new Directive which, among other things, follows largely the best practice approach in the Final Report: Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax

Fourthly, specific issues in respect of financial institutions are not discussed in detail in this article.[15]

2. Chevron—a case study

2.1. Tax structure from 2004 to 2009[16]

The *Chevron* tax case was the first transfer pricing case on the issue of "arm's length interest rate" in Australia.[17] The case was complex and expensive to run.[18] The court hearing lasted five weeks, which is "almost unprecedented in Australian tax litigation".[19]

Before proceeding, it is important to note that the discussion of the tax structure below aims to highlight the problems arising from intra-group debt with respect to interest limitation regimes. Other issues, including transfer pricing issues, argued in the case are not discussed in detail. It is also important to note that Chevron's two tax structures as described below involved the use of hybrid entities. At the time of writing this article, it is unclear whether the OECD's recommendations in Action 2 will be effective in coping with these kinds of structures. This is because the answer depends on the detailed rules actually implemented by countries, as well as whether or not a country decides to introduce the rules at all. Perhaps more importantly, anti-hybrid rules are unlikely to be applicable if the interest income in question is subject to tax in the recipient's country. This is so even if the applicable tax rate is very low. In other words, despite Action 2, MNEs will most likely continue to engage in similar tax structures using intra-group debt aiming to exploit differential company tax rates among countries.

avoidance practices that directly affect the functioning of the internal market (available at: *http://data.consilium.europa.eu/doc/document/ST-10539-2016-COR-1/en/pdf* [Accessed 20 January 2017]).

[15] For a discussion of the specific issues for banking and insurance groups, see: Final Report, above fn.2, Ch.10. This is one of the areas where the OECD is continuing its work after the release of the Final Report. The Discussion Draft on this issue was released by the OECD on 28 July 2016: OECD, *Public Discussion Draft: BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors* (28 July 2016), available at: *http://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf* [Accessed 20 January 2017]. The final recommendations for these issues were released on 22 December 2016: OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2016 Update* (Paris: OECD Publishing, 2016).

[16] The *Chevron* tax case (*Chevron*, above fn.7, [2015] FCA 1092) covered the period from 2004 to 2008. However, the tax structure was in place until it was replaced by the new structure in 2010.

[17] The issue of determining arm's length interest rate has been the main point of argument in other overseas cases, for example, see the analysis of two cases in Finland and Sweden in 2010: M. Helminen, "Determining the Arm's Length Interest Rate of an Intra-Group Loan" (2011) 51(4) *European Taxation* 153 (April). Another recent tax case in Australia, *Orica Ltd v Commissioner of Taxation* [2015] FCA 1399, also involved intra-group debt of a domestic MNE, highlighting that the use of intra-group debts is popular for both foreign and domestic MNEs. This case was eventually decided on the general anti-avoidance provision in Australia. A common feature between these two Australian tax cases was that Australia's thin capitalisation regime was a non-issue, suggesting that the regime is often not effective for tackling tax structures using intra-group debts. More will be said about this point below.

[18] The case involved 11 barristers, including five Queen's Counsel and Senior Counsel. The legal costs for the Australian Taxation Office (ATO) were around AUD $10 million. Chevron has not disclosed its legal costs, but anecdotal evidence suggests the amount to be of at least a similar magnitude. It is interesting to note that even one of the barristers in the case conceded that such spending of legal costs was "not an efficient allocation of resources": Burnett, above fn.3, 332. The ATO has won the case at first instance, but Chevron has appealed to the Full Federal Court.

[19] Vann and Cooper, above fn.9, 1.

Furthermore, Chevron's tax structure as discussed below represents a snapshot in time, and has evolved over time.[20] Nevertheless, the analysis of the tax structure is relevant and sets the stage for the evaluation of the best practice approach recommended for Action 4 (below).

The tax structure in the *Chevron* case is depicted in Figure 1.

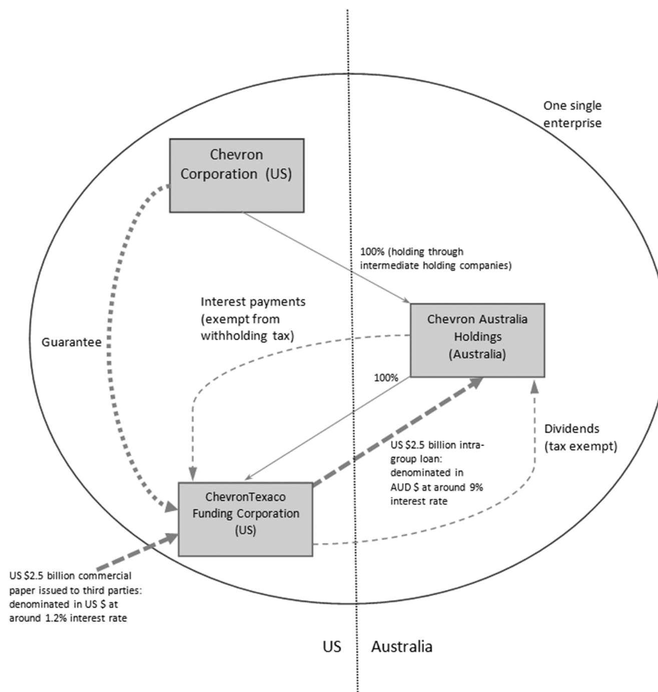

Figure 1

Under the structure, Chevron Australia Holdings Pty Ltd (CAH) established a wholly owned subsidiary in Delaware in the US, namely ChevronTexaco Funding Corporation (CFC). This subsidiary had no employees.[21] It was a special purpose vehicle whose only activity was to issue commercial paper denominated in US dollars to raise US $2.5 billion.[22] It was able to raise the money for an interest rate of around 1.2 per cent[23] due to the guarantee provided by the ultimate parent company Chevron Corporation.[24]

CFC in turn lent the money to CAH. However, the terms of this intra-group debt differed significantly from those of the underlying commercial paper in three key areas. First, while the commercial paper was denominated in US dollars, the intra-group loan was denominated in

[20] See section "Tax structure from 2010" below.
[21] *Chevron*, above fn.7, [2015] FCA 1092 at [119].
[22] *Chevron*, above fn.7, [2015] FCA 1092 at [107].
[23] Commissioner of Taxation, *Respondent's outline of submissions* (ATO Submissions) (Federal Court of Australia File number: NSD440/2013), para.7. For comparison, the weighted-average interest rate on Chevron Corporation's commercial papers at 31 December 2015 was even lower at 0.26%: Chevron Corporation, *Chevron Corporation 2015 Annual Report*, Note 19.
[24] *Chevron*, above fn.7, [2015] FCA 1092 at [138]. The court hearing revealed that "when Chevron went to the market to borrow either directly or through a subsidiary, it always tried to borrow by using its AA credit rating", at [145].

Australian dollars. This is despite the fact that the actual cash flows between the two companies—including drawdowns of the loan amount, interest payments and repayments of the loan principal—were all in US dollars through CFC's bank accounts in the US.[25] Secondly, despite the interest rate on the commercial papers being around 1.2 per cent, CFC charged an interest rate of around 9 per cent on the intra-group debt.[26] Thirdly, although Chevron Corporation provided a guarantee for CFC's commercial paper, the intra-group debt did not have any security or operational and financial covenants.[27]

The interest income of CFC was not subject to tax either in Australia or the US. In particular, the interest payments made by CAH to CFC—which amounted to AUD $1.5 billion from 2004 to 2008[28]—were exempt from withholding tax in Australia pursuant to a specific exemption for public offers.[29] At the same time, the interest income of CFC was also not taxable in the US, as the intra-group interest payments were fully offset for US tax purposes.[30] In particular, the US Internal Revenue Service confirmed in its letter dated 25 June 2009 that from 2004 to 2008 CAH was a check-the-box entity and therefore the interest expense paid by CAH under the intra-group debt was fully offset against the corresponding interest income of CFC for US tax purposes.[31]

Through a round robin, the interest payments received by CFC—after deducting interest expenses on the commercial paper—were paid back to CAH as dividends.[32] The dividends were exempt from tax under the participation exemption provision in Australia.[33]

The ATO challenged the structure, and issued assessments based on an interest rate of around 5 per cent.[34] The court rejected the taxpayer's appeal on the basis that Chevron failed to satisfy

[25] *Chevron*, above fn.7, [2015] FCA 1092 at [268]. The court hearing also revealed that "88% of [CAH]'s … revenues were in US dollars", at [288]. Chevron's justification for the interest payments on the intra-group debt to be in US dollars—despite the fact that the intra-group debt was denominated in Australian dollars—was "for administrative convenience": CAH, *Applicant's outline of submissions* (Federal Court of Australia File number: NSD440/2013), para.56.

[26] ATO Submissions, above fn.23, para.6. In particular, the interest on the intra-group debt was payable monthly at a rate equal to 1-month AUD-LIBOR-BBA plus 4.14%: *Chevron*, above fn.7, [2015] FCA 1092 at [2].

[27] *Chevron*, above fn.7, [2015] FCA 1092 at 87.

[28] ATO Submissions, above fn.23, para.69.

[29] Income Tax Assessment Act 1936 (ITAA 1936) s.128F. There are a few interesting points about this interest withholding tax exemption. First, for the purpose of the exemption, the tax law looks through the corporate veil and grants the exemption to an Australian entity even if, among other things, its overseas wholly-owned subsidiary, instead of the Australian entity itself, issues the commercial paper: ITAA 1936 s.128F(8). While Chevron benefited from this look through treatment with respect to the interest withholding tax exemption, the tax law does not apply consistently the same treatment for the purposes of deciding the appropriate interest rate that should be borne by CAH. Secondly, the tax law specifically stipulates that the "look through" exemption applies only if the overseas subsidiary is established in the US "or in another country specified in the regulations": ITAA 1936 s.128(8). In fact, no other country has been specified for this purpose. It is not clear why the US is the only country in the world that is acceptable for the purposes of the exemption. In any case, Chevron's tax structure was well designed to benefit from this specific exemption.

[30] ATO Submissions, above fn.23, para.73.

[31] ATO Submissions, above fn.23, para.73.

[32] ATO Submissions, above fn.23, para.71. The total amount of dividends from 2004 to 2008 was about AUD $1.1 billion.

[33] ATO Submissions, above fn.23, para.8.

[34] The 5% was determined on a basis that the arm's length interest rate for CAH should be AUD LIBOR + 0.09%. The 0.09% was based on the assumption that CAH had a AA credit rating: D. Preshaw, "Transfer pricing and the Chevron case" (2016), paper presented at the 31st National Convention of the Tax Institute, available at: *http://www*

the onus upon it to prove that the assessments were excessive.[35] Chevron has appealed to the Full Federal Court.

It is important to note that despite "losing" the case, Chevron still enjoyed a substantial tax benefit: for the group as a whole, the interest deductions at an interest rate of 5 per cent far exceeded the group's "real" third party interest expenses at 1.2 per cent. Furthermore, the thin capitalisation regime in Australia—which supposedly should be the first line of defence against these kinds of tax avoidance structures—was proved to be ineffective. CAH had no problem satisfying the requirements of the regime.[36]

2.2. Tax structure from 2010

The recent Senate enquiry into corporate tax avoidance in Australia has revealed additional information about the tax structure of Chevron, which provides further insights into the use of intra-group debt in practice. In particular, the Senate hearings revealed that the tax structure depicted above—which was set up in 2003—has been replaced by a new structure from 2010 and CFC was eventually dissolved in 2011.[37]

The tax structure of Chevron from 2010 is depicted in Figure 2.[38]

.taxinstitute.com.au/ticonventionpresentation/transfer-pricing-and-the-chevron-case-presentation [Accessed 20 January 2017], 4.

[35] As this article's focus is on interest limitation regimes, the transfer pricing issues involved in the case are not discussed in detail. *Chevron*, above fn.7, [2015] FCA 1092 highlights a key issue of relying on transfer pricing rules to resolve BEPS by interest deduction, namely the significant difficulty in ascertaining the elusive "arm's length" interest rate. In particular, the ATO put forward six different possible "arm's length" interest rates in its arguments: *Chevron*, above fn.7, [2015] FCA 1092 at [498]. For a well-reasoned criticism of the transfer pricing regime with respect to determining the arm's length interest rates, see Vann and Cooper, above fn.9, 8–17.

[36] *Chevron*, above fn.7, [2015] FCA 1092 at [592].

[37] Senate Economics References Committee, transcript of hearing on 18 November 2015, available at: *http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommsen%2Fb56c040c-ca7a-4787-9db9-c07c9d5f5f6e%2F0003;query=Id%3A%22committees%2Fcommsen%2Fb56c040c-ca7a-4787-9db9-c07c9d5f5f6e%2F0000%22* [Accessed 20 January 2017]; and Chevron's submission to the Senate enquiry, Submission 121, dated 30 July 2015 (Chevron Submission 121), available at: *http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions* [Accessed 20 January 2017], 7. The reasons for the change of Chevron's tax structure were not revealed in the Senate enquiry. A possible explanation is that, in the course of handling the audit and challenge from the ATO, Chevron reviewed the old tax structure and decided that it might be too aggressive and therefore replaced it with a less risky structure. The relatively prudent approach may also be influenced by the fact that the intra-group debt of AUD $35 billion under the new structure was significantly more than the US $2.5 billion intra-group debt under the old structure.

[38] The diagram is prepared based on information disclosed in Chevron Submission 121, above fn.37.

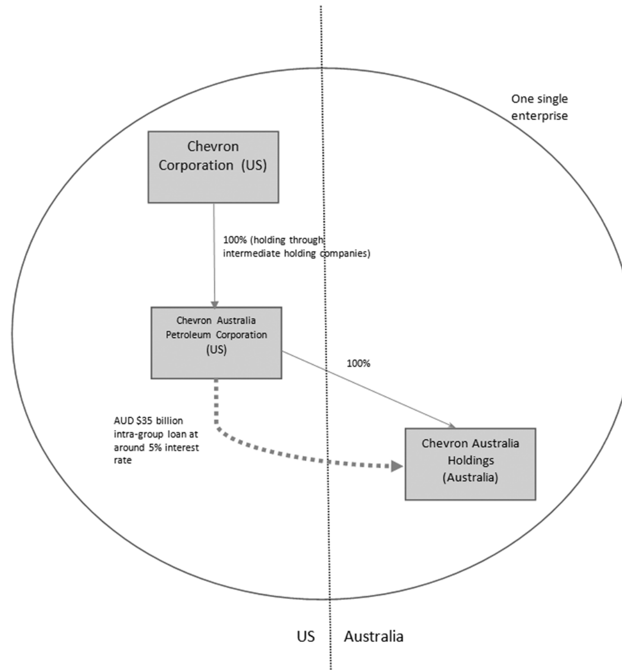

Figure 2

On one hand, the new structure is relatively simple as compared to the old one. The intra-group debt of CAH is now with its immediate parent company, Chevron Australia Petroleum Corporation (CAPC), instead of with the more complex structure of CFC. The intra-group debt was not secured and the interest rate is bank bill swap rate plus 2.63 per cent, which was approximately 5 per cent in 2014.[39]

On the other hand, the new structure involves much more significant amounts than those of the old one. The intra-group debt under the new structure is AUD $35 billion[40] and the interest expenses on the debt for 2014, one single year alone, amounted to AUD $1.84 billion.[41] This interest expense claimed in Australia contrasts sharply with the financial position of the group. In particular, the 2014 Annual Report of Chevron Corporation revealed that the group as a whole had *no* interest expense.[42]

The new structure is different from the old one with respect to withholding tax. While the old structure achieved an exemption of the interest withholding tax, CAH has been paying 10 per cent withholding tax on its interest payments on the intra-group debt under the new structure.[43]

[39] CAH Financial Statements for the Year Ended 31 December 2014, note 17 to the financial statements.
[40] CAH Financial Statements for the Year Ended 31 December 2014, note 17 to the financial statements.
[41] Chevron Submission 121, above fn.37, 8.
[42] Chevron Corporation, *Chevron Corporation 2014 Annual Report*, 4. This issue is discussed in more detail in the next section.
[43] Chevron Submission 121, above fn.37, 8.

Similar to the old structure, the interest payments from CAH to CAPC were not recognised for US tax purposes. In particular, Chevron confirmed in the Senate enquiry that[44]:

> "Under US tax rules, CAPC and [CAH] are both treated as members of Chevron's US tax consolidated group and therefore any transactions occurring between the two entities offset and eliminate in consolidation."

In other words, the interest payments from CAH to CAPC were not taxable in the US.

Similar to the old structure, CAH also complied with Australia's thin capitalisation regime under the new structure. In its submission to the Senate enquiry into corporate tax avoidance, Chevron emphasised that CAH's "debt levels complied with the thin capitalisation rules for all relevant years".[45]

The following section provides a summary of the financial positions of the Chevron group, aiming to highlight the issues arising from the lack of linkage between an interest limitation regime and the net third party interest expense of a MNE.

2.3. The "real" financial positions of the Chevron group

The interest payments made by CAH under the new tax structure and the net third-party interest expense incurred by the Chevron group, as disclosed in its Annual Reports for 2011 to 2014, were summarised in the following table:

	2011	**2012**	**2013**	**2014**
CAH:				
Interest payments on intra-group debt[46]	*AUD $0.7B*	*AUD $1B*	*AUD $1.3B*	*AUD $1.8B*
Chevron group:				
Interest expense per Income Statement[47]	*US $0*	*US $0*	*US $0*	*US $0*

[44] Chevron, Submission dated 18 December 2015 to the Senate enquiry into corporate tax avoidance, Submission No.124 (Chevron Submission 124), available at: *http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions* [Accessed 20 January 2017], 5.

[45] Chevron Submission 121, above fn.37, 8. The Senate enquiry also revealed that the new structure is under audit by the ATO, possibly with respect to the issue of whether or not the interest rate charged on the intra-group debt is arm's length. A detailed analysis of *Chevron*, above fn.7, [2015] FCA 1092 is beyond the scope of this article. For the present purpose, it should be noted that it is likely that the new structure would be more difficult for the ATO to challenge under the transfer pricing rules for a number of reasons. First, the judge in *Chevron* accepted that the intra-group debt under the old structure was denominated in AUD $ and the "arm's length" interest rate should be determined on that basis, even though in practice all the cash flows with respect to the intra-group debt were transacted in US $: *Chevron*, above fn.7, [2015] FCA 1092 at [583]. It is possible that the "arm's length" interest rate on the intra-group debt under the new structure would be determined on a similar basis, and therefore would be around 5%. Secondly, the judge appeared to accept implicitly that for a loan between a parent company and its subsidiary, "arm's length" interest rate should be determined on the basis that the parent-subsidiary relationship is ignored: *Chevron*, above fn.7, [2015] FCA 1092 at [604]. See also Greenwoods Herbert Smith Freehills, above fn.9, 5. If that is the case, the interest rate under the new structure—where the intra-group debt is between CAH and its immediate parent company—would be more difficult for the ATO to challenge.

[46] Chevron Submission 121, above fn.37, 8.

[47] Chevron Annual Reports, available at: *http://www.chevron.com/investors/financial-information* [Accessed 20 January 2017], p.4 of the respective reports for 2011 to 2014.

	2011	2012	2013	2014
Capitalised interest[48]	US $288M	US $242M	US $284M	US $358M
- equivalent AUD $ (@ 1.2 exchange rate)	*AUD $0.3B*	*AUD $0.3B*	*AUD $0.3B*	*AUD $0.4B*

This table highlights that the interest deduction claimed by CAH on the intra-group debt far exceeded the "real" interest costs borne by the group. This is the case even if capitalised interest of the group is taken into account. This begs the question of whether a tax regime that is designed to limit interest expenses should ignore the actual financial positions of a MNE group.

Chevron's 2014 Annual Report also discloses other interesting information that provides further insights into the importance of linking an interest limitation regime with a MNE's net third-party interest expense. First, for the year ended 31 December 2014, the amount of "real" total third-party debt of the Chevron group was US $28 billion,[49] equivalent to approximately AUD $34 billion (at US $1 = AUD $1.2). This amount is ironically *less than* the intra-group debt of AUD $35 billion between CAH and CAPC. The comparison may be more dramatic if the amount of cash and cash equivalents of the Chevron group, namely US $13 billion is taken into account.[50] In that case, the net debt of the group would be US $15 billion, or AUD $18 billion, implying that the amount of the intra-group debt of CAH was almost double the "real" net debt of the Chevron group.

Secondly, the 2014 Annual Report reveals that Chevron raised additional debt in the year "to take advantage of historically low interest rates".[51] The table below summarises the "real" interest rates borne by the Chevron group in 2014:

	Chevron group
Long-term notes	0.33%–4.95%[52] (weighted average = 2%)
Commercial paper	0.12%[53]

The table demonstrates again that the 5 per cent interest rate charged on the intra-group debt of CAH was substantially higher than the "real" interest rate borne by the group.

The following section provides a brief summary of Australia's thin capitalisation regime, for the purposes of facilitating the evaluation of alternative interest limitation regimes below.

[48] Chevron Annual Reports, above fn.47, Notes 24 and Note 25 to the 2013 and 2014 Consolidated Financial Statements respectively.
[49] Chevron Corporation, *Chevron Corporation 2014 Annual Report*, 20.
[50] Chevron Corporation, *Chevron Corporation 2014 Annual Report*, 20.
[51] Chevron Corporation, *Chevron Corporation 2014 Annual Report*, 20.
[52] Chevron Corporation, *Chevron Corporation 2014 Annual Report*, 56. It should be noted that the interest rates of all the notes were substantially lower than 5%, except the "4.95% notes due 2022". However, these notes amounted to only US $1.5 billion, which is much less than the AUD $35 billion intra-group debt with an interest rate of around 5%.
[53] Chevron Corporation, *Chevron Corporation 2014 Annual Report*, 57.

2.4. Australia's thin capitalisation regime

Australia's thin capitalisation regime was first introduced in 1987 and experienced a major reform in 2001.[54] It aims to limit interest deductions based on the level of total debt of an entity. In broad terms, the thin capitalisation regime applies to limit interest deductions if an entity fails to satisfy *any* of the following three tests, namely: 1. the safe harbour test based on a debt-to-asset ratio; 2. the arm's length debt test[55]; and 3. the worldwide gearing ratio test.[56]

The thin capitalisation regime is complex, occupying nearly 100 pages of legislative provisions. A detailed analysis of the regime is beyond the scope of this article. For the present discussion, it is useful to note that in practice, most MNEs—including Chevron—rely on the safe harbour test to pass the thin capitalisation regime. In particular, the ATO statistics shows that

> "for the 2013 [income] year, out of a total of 2,757 entities that have lodged thin capitalisation schedules, 2,670 entities applied the safe harbour test".[57]

In broad terms, the current safe harbour debt limit is 60 per cent on a debt-to-asset basis.[58]

[54] The current regime is in Income Tax Assessment Act 1997 (ITAA 1997) Division 820, and applies to all debt of an entity, instead of applying only to debt from related parties under the previous rules. For a brief history of Australia's thin capitalisation regime, see: Vann and Cooper, above fn.9, 24–25. For a brief summary of thin capitalisation regimes in the world, including the historical evolution of the regime in Germany, see M. Ruf and D. Schindler, "Debt Shifting and Thin-Capitalization Rules — German Experience and Alternative Approaches" [2015] *Nordic Tax Journal* 17, 19–20, 22–24 and 26–27.

[55] The arm's length debt test was subject to a recent review by the Board of Taxation in Australia, which basically endorsed the test and suggested administrative measures to reduce compliance costs in the application of the test: Board of Taxation, *Review of the Thin Capitalisation Arm's Length Debt Test — A Report to the Assistant Treasurer* (December 2014), available at: *http://taxboard.gov.au/files/2015/07/ALDT_Report.pdf* [Accessed 20 January 2017]. This contrasts with the OECD's findings in its work on Action 4. In particular, the OECD ruled out the arm's length test from the consultation process early because of a number of problems with the test, namely, that the test "can be resource intensive and time consuming for both taxpayers and tax administration … the outcomes of applying [the test] can be uncertain … some countries with experience of applying [the test] in practice expressed concerns over how effective it is in preventing [BEPS]": Discussion Draft, above fn.5, para.22. In addition, the test "has an inherent tendency to overstate deductible interest", as in the real business world "healthy businesses rarely borrow as much as they could, preferring to leave a large buffer to demonstrate to the market their robustness and flexibility": R. Vann and C. Burnett, Submission to BEPS Action 4 Discussion Draft, dated 6 February 2015 in OECD, *Comments received on Public Discussion draft: BEPS Action 4: Interest Deductions and Other Financial Payments: Part 1* (11 February 2015), available at: *https://www.oecd.org/tax/public-comments-action-4-interest-deductions-other-financial-payments.htm* [Accessed 20 January 2017], 235. For a discussion of the UK's arm's length test and its problems, see C. Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach" (2014) 6(1) *World Tax Journal* 40, 46–47 (February). Ironically, the arm's length test appeared to have strong support from businesses as revealed in the consultation process: A. Athanasiou and D. Stewart, "OECD Action 4 Draft Consultation Focuses on Fixed Ratios" (2015) *Worldwide Tax Daily* (18 February 2015).

[56] In very broad terms, the worldwide gearing ratio test requires that the gearing ratio of an entity cannot be greater than that of the entity's worldwide group: see for example the definition of the test for inward investment vehicle (general) in ITAA 1997 s.820-216.

[57] Board of Taxation, above fn.55, para.2.10.

[58] ITAA 1997 s.820-195. The thin capitalisation regime applies different tests for different categories of entities. For the purposes of this article, the analysis focuses on the rules applicable to "inward investment vehicle (general)", which are applicable to Chevron's tax structures. The safe harbour limit was tightened from 75% to the current 60% in 2014. News reports suggested that the government might further tighten the limit to 50% in the 2016 Budget. However, the government eventually decided not to announce any change to the test, possibly due to "big business lobbies": Thomson Reuters, *Weekly Tax Bulletin* (2016) No.18, para.542; and N. Khadem, "Aussies Unconvinced by Lawmakers' Tough Talk on MNEs" (2016) 82 *Tax Notes International* 1273 (27 June 2016), 1274. Another interesting point to note about Australia's thin capitalisation regime is that the regime was weakened in 2008 when the law was

The *Chevron* case revealed that, despite the US $2.5 billion intra-group debt created under the old tax structure, the debt-to-equity ratio of CAH was approximately 47 per cent in 2002.[59] This implied a debt-to-asset ratio of around 68 per cent, which was lower than the prevailing safe harbour test ratio of 75 per cent.[60] Furthermore, the thin capitalisation regime failed to address the issue that the interest rate on the US $2.5 billion loan was substantially higher than that of the underlying third party commercial papers of CFC. This issue is discussed in more detail in section "Allowing Interest deduction exceeding net third party interest expense" below.

Despite these problems of the thin capitalisation regime, the Australian Government's response to the OECD's Action 4 recommendations was that "Australia has already tightened its Thin Capitalisation rules … No major issues expected".[61]

Competing policy objectives

The Australian Government's lenient attitude towards the thin capitalisation regime may be due to the tension between two competing policy objectives, namely promoting foreign investment and anti-avoidance.[62] For instance, the Board of Taxation described the tension in this way (emphasis added)[63]:

amended to allow substantial flexibility in the identification and valuation of intangible assets: Explanatory Memorandum to Tax Laws Amendment (2008 Measures No. 5) Act 2008, Chapter 2. In particular, the amended legislation allows entities to do the followings with respect to the thin capitalisation regime: 1. to give a value to certain intangible assets that is "greater than that permitted to be recognised by the … accounting standards"; 2. to recognise "an internally generated intangible asset, where recognition is … prohibited under accounting standards …"; and 3. to revalue an intangible asset using valuation methods not allowed under accounting standards: Explanatory Memorandum to the 2008 Act, paras 2.14, 2.19 and 2.20. It is puzzling why the government believes that it is appropriate to allow taxpayers these options for an essentially anti-avoidance regime.

[59] *Chevron*, above fn.7, [2015] FCA 1092 at [99].

[60] Chevron Australia Holdings Pty Ltd, *Applicant's outline of submissions*, above fn.25, para.43. It is therefore not surprising that Chevron argued strongly against changes to the thin capitalisation regime, and further argued that even if the current safe harbour debt test were to change to an interest-to-EBITDA ratio test, the latter test "should be offered as an optional alternative, which *must be in addition to the existing 'safe harbour' thin capitalisation rules*" (emphasis added): Chevron's submission to BTWG Discussion Paper, dated 21 September 2012, available at: *http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/Business-tax-reform/Submissions* [Accessed 20 January 2017], 5.

[61] The Treasurer, Media Release, *OECD report supports Australian Government action on multinational tax avoidance* (6 October 2015), available at: *http://sjm.ministers.treasury.gov.au/media-release/003-2015/* [Accessed 20 January 2017]. The opposition party has proposed replacing the current thin capitalisation regime with a worldwide gearing ratio based on equity or assets. However, the government has not shown any interest in this proposal. This attitude of the Australian Government may be compared with that of the UK, which has proposed the introduction of "rules necessary to tackle BEPS involving interest in line with the OECD recommendations": HM Treasury and HM Revenue & Customs, *Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation* (May 2016), available at: *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525923/tax_deductibility_second_consultation_v2.pdf* [Accessed 20 January 2017], para.B.3. This decision to reform the current regime to limit interest deduction was particularly remarkable, given that "in general, respondents [to the consultation of the proposal] were not in favour of the UK introducing an interest restriction in line with the OECD proposals. The majority of respondents argued that the UK's existing rules already provide sufficient protection from BEPS": para.B.2.

[62] Other countries are likely to be faced with a similar dilemma in the design of their interest limitation regimes. See for example the experience in Sweden: P. Melz, "A proposal for business tax reform in Sweden" [2015] BTR 6, 6.

[63] Board of Taxation, above fn.55, paras 2.1 and 2.2.

> "The thin capitalisation rules are … where a number of important taxation and economic policies intersect. These policies include *protecting the corporate tax base*, ensuring that commercial investment decisions are not impeded … An important policy concern … is their *impact on foreign investment into Australia*."

In particular, while the thin capitalisation regime is designed to tackle base erosion, the chosen fixed ratio in the regime was "a pragmatic and deliberate policy, taking into account Australia's international competitive position".[64]

This article does not intend to analyse in detail the tension between these two policy objectives. Instead, this article focuses on evaluating the effectiveness of the interest limitation regimes with respect to BEPS, aiming to provide useful information for tax policy makers in the design of the regimes. Nevertheless, before proceeding, two comments on this issue are in order.

First, the OECD explicitly stated in the Final Report that a country

> "should not apply a higher [fixed] ratio due to a policy of attracting international investment into a country through lenient interest limitation rules".[65]

Secondly, a distinction between "real" third party interest expense and artificially created intra-group interest expense is critical in this debate. The OECD's position on this distinction seems clear in its discussion of the factors that countries should consider in setting the fixed ratio (emphasis added)[66]:

> "A country may apply a higher ratio … where it applies a macro-economic policy to encourage *third party lending not related to base erosion and profit shifting*, to increase investment (e.g. in infrastructure)."

The competitiveness argument that is often put forward to support a lenient interest limitation regime is premised on the assumption that limiting interest deduction of a business may have a negative impact on investment decisions. This assumption may be true for genuine third party interest expense incurred by a company, as denying deduction of "real" interest expense increases the cost of debt financing. However, the same logic should not automatically apply to intra-group interest expense which is artificially created between group members for tax avoidance purposes. It is doubtful whether this kind of intra-group interest expense may have significant impact on genuine commercial decisions.

The importance of the linkage between interest deduction of an entity and net third party interest expense of its group is explored further in the next section.

3. Separate entity approach versus group approach

The issue of whether interest limitation should be based on the position of an entity or its group was analysed in Action 4 as one of the key structural design features of an interest limitation

[64] R. Vann, "Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?" [2013] BTR 59, 71. See also: Review of Business Taxation, *A Tax System Redesigned* (1999), available at: *rbt.treasury.gov.au/publications/paper4*/ [Accessed 20 January 2017], 659–667.

[65] Final Report, above fn.2, para.109.

[66] Final Report, above fn.2, para.108. For a discussion of the specific issues with respect to infrastructure projects, see: Discussion Draft, above fn.5, para.215.

regime.[67] With respect to this issue, it has been argued elsewhere that in general, the application of the enterprise doctrine—under which a corporate group under the common control of the parent company is regarded as one single enterprise—may be more likely to be effective in addressing BEPS issues.[68] The analysis of the relative advantages and disadvantages of the group approach in Action 4 provides important insights into the application of the enterprise doctrine in interest limitation regimes. In contrast, the separate entity approach represents an application of the traditional single entity doctrine, under which a company is in general treated as a separate taxpayer, even if it is a wholly owned subsidiary of another company. The following paragraphs analyse these two approaches.

3.1. Separate entity approach: fixed ratio rules

The OECD stated that the key advantage of a fixed ratio rule is that, in comparison with a group-wide rule, it is relatively simple to apply, as it is "based entirely on the entity's own financial position".[69]

However, the sole reliance on the financial position of an entity is ironically also the main problem with this rule. The lack of linkage with the "real" net third party interest expense of a group dictates that a fixed ratio rule would struggle to achieve the main objective of Action 4, namely, to prevent excessive interest deductions over a MNE's net third party interest expense.[70] The OECD repeatedly emphasised the link between interest deductions by a company and the actual net third party interest cost of its group as one of the key policy objectives of Action 4.[71]

[67] Discussion Draft, above fn.5, 2. For a review of the current approaches adopted by countries to address the BEPS issues arising from interest expenses, see: Discussion Draft, above fn.5, Ch.III; Final Report, above fn.2, para 10–20; and also B. Arnold, *International Tax Primer* (Alphen aan den Rijn: Wolters Kluwer, 2016), 1145–118; and Traversa, above fn.6, 610–613.

[68] A. Ting, "iTax — Apple's international Tax Structure and the Double Non-Taxation Issue" [2014] BTR 40, 60–65.

[69] Discussion Draft, above fn.5, para.147; and Final Report, above fn.2, para.86. A fixed ratio rule may also be introduced to address the issue of distortions between the tax treatment of debt and equity: Discussion Draft, above fn.5, para.150. A detailed discussion of this issue is beyond the scope of this article.

[70] A fixed ratio rule has other problems. First, it is a blunt measure which fails to take into consideration different financial positions of MNEs: Final Report, above fn.2, para.86. The benchmark fixed ratio of the rule—which in general applies to all entities in most sectors—is thus inevitably arbitrary, and is likely to be "too high for some entities (giving rise to opportunities for [BEPS]) and at the same time too low for others (giving rise to double taxation)": Discussion Draft, above fn.5, para.149.

[71] For example, this policy objective was mentioned in: OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013), available at: *https://www.oecd.org/ctp/BEPSActionPlan.pdf* [Accessed 20 January 2017], 16; Discussion Draft, above fn.5, paras 4, 10, 27 and 60; and Final Report, above fn.2, 11. The importance of this linkage is also emphasised in the OECD's discussion of targeted rules. In particular, "an approach which uses a general rule supplemented by targeted rules … should provide countries with the comfort that the main risks posed by base erosion and profit shifting are addressed, while ensuring that groups are able to *obtain relief for their real net third party interest expense*" (emphasis added): Final Report, above fn.2, para.168; and Discussion Draft, above fn.5, para.179. It should be noted that the policy objective of limiting interest deduction to net third party interest expense does not mean that a parent company is prevented from financing its subsidiary using debt instead of equity. There may be genuine commercial reasons for a group to do so. However, for anti-BEPS purposes, this policy objective ensures that a group should not deduct internally created interest expense in excess of the "real" interest expense of the group. In theory, if part of the intra-group interest expense is disallowed, the corresponding interest income may still be taxable in the hands of another group company. However, in practice, this is unlikely to happen for well-advised MNEs.

This linkage is critical for tackling BEPS by MNEs as it pierces through the corporate veil and focuses on the real financial position of a corporate group.

3.1.1. Debt-to-equity rule

Two common models of fixed ratio rules are debt-to-equity rules and interest-to-earnings rules. Despite recognising the problems of using the levels of debt and equity as reference in an interest limitation regime,[72] the OECD's conclusion with respect to debt-to-equity rules is less definite than expected. This is possibly due to the fact that the debt-to-equity rule is the most common regime for countries that are applying fixed ratio rules.[73] The countries involved in the work of Action 4 agreed that these rules "should not be included as a general interest limitation rule within a best practice approach … *although … this is not intended to suggest that these tests cannot play a role within an overall tax policy to limit interest deductions*" (emphasis added).[74] The fact that the Final Report leaves this option open suggests that some participating countries in Action 4 may have insisted on keeping their debt-to-equity regimes.

3.1.2. Interest-to-earnings rule

The fundamental principle underlying an interest-to-earnings rule is that

> "an entity should be able to deduct interest expense up to a specified proportion of [earnings], ensuring that a portion of an entity's profit remains subject to tax in a country".[75]

In the design of an earnings-based fixed ratio rule, there are two key factors to decide: first, the definition of earnings; and secondly, the benchmark ratio. The following paragraphs analyse these two factors in turn.

The definition of earnings is important, as it affects directly the amount of interest deduction allowed under an earnings-based fixed ratio rule. The OECD prefers earnings before interest, taxes, depreciation and amortisation (EBITDA) as the definition for two reasons. First, it is "a guide to the ability of an entity to meet its obligations to pay interest".[76] Secondly, EBITDA is a relatively widely tested definition, as it is the most common definition of earnings in existing earnings-based regimes.[77]

Another issue with respect to the definition of earnings is whether it should be based on tax or accounting figures. The OECD prefers to use tax figures in an interest-to-earnings fixed ratio

[72] Final Report, above fn.2, paras 58 and 59.
[73] Final Report, above fn.2, para.17.
[74] Final Report, above fn.2, para.17.
[75] Final Report, above fn.2, para.85.
[76] Discussion Draft, above fn.5, para.157.
[77] Discussion Draft, above fn.5, para.157. A small number of countries use earnings before interest and taxes (EBIT): ibid. The definition of earnings should exclude tax exempt income, thus preventing BEPS structures which use interest to fund tax exempt income: Discussion Draft, above fn.5, para.155; and Final Report, above fn.2, para.89.

rule for three reasons.[78] First, tax numbers are "reasonably straightforward to apply and audit".[79] Secondly, using tax EBITDA should avoid in most cases the risk that an entity with negative EBITDA is required to pay tax due to interest disallowed.[80] Thirdly, and perhaps most importantly for anti-BEPS purposes, using tax EBITDA provides a strong link between interest deduction and taxable income, thus rendering the rule more robust to combat BEPS.[81]

The other key factor to decide for an interest-to-earnings rule is the benchmark fixed ratio. This is a controversial issue, as there is constant tension between the policy objectives of anti-BEPS and competitiveness. Setting the benchmark ratio too high renders the fixed ratio rule less effective in combating BEPS, while businesses often argue that a low benchmark ratio would render a country's tax system less competitive and therefore discourage investment.[82]

The most common benchmark ratio in existing earnings-based fixed ratio rules is 30 per cent.[83] However, both empirical and anecdotal evidence indicates that this benchmark ratio may be too high to be effective in addressing BEPS risks.[84] In particular, the OECD observed that (emphasis added)[85]:

> "For the largest non-financial sector groups, *the vast majority* have a net interest to EBITDA ratio of below 10 per cent and many do not have any net interest expense."

The observation was based on an empirical analysis of non-financial sector companies from the Global top 100 companies by market capitalisation for the years 2009 and 2013. The results are summarised in the following table[86]:

Year	**2009**	**2013**
Total number of companies in the analysis for that year	77	79
Number of companies with net interest/EBITDA ratio below 10%	69	75
Number of companies with no net interest expense	15	18

[78] In contrast, the OECD recommended the use of accounting numbers of an earnings-based group ratio rule: Final Report, above fn.2, para.123. These inconsistent choices of tax and accounting numbers between a fixed ratio rule and a group ratio rule may be justified by the practical constraints imposed by the difficulty faced by an entity in determining the net third party interest-to-EBITDA ratio of its group if tax numbers are used, as well as the fact that consolidated financial statements of corporate groups are often readily available to both taxpayers and tax authorities: Final Report, above fn.2, paras 121 and 122.
[79] Final Report, above fn.2, para.88.
[80] Final Report, above fn.2, para.88.
[81] Final Report, above fn.2, para.88.
[82] Final Report, above fn.2, para.93. Some commentators had suggested different benchmark ratios for different industries; however, this approach would be complex and could not address the issue of varying gearing ratios within the same industry. For a brief discussion of this issue, see Burnett, above fn.3, 330.
[83] Discussion Draft, above fn.5, para.158. In particular, out of the eight countries surveyed by the OECD, six—namely, Germany, Greece, Italy, Norway, Portugal and Spain—have a benchmark ratio of 30%, while Finland has 25% and the US 50%: Discussion Draft, above fn.5, para.158.
[84] Discussion Draft, above fn.5, para.159.
[85] Discussion Draft, above fn.5, para.27.
[86] The table is prepared based on the data provided in: Discussion Draft, above fn.5, para.159.

It is clear from the table that a benchmark ratio of 30 per cent is likely to be excessively generous for these MNEs. This ratio would allow most of these MNEs to claim interest deductions well in excess of their actual net third party interest expense.

Despite recognising that 30 per cent is likely to be a generous benchmark ratio, as well as other fundamental problems of a fixed ratio rule as discussed above, the OECD included this rule in its best practice approach in the Final Report.[87] This issue is discussed in more detail in section "The best practice approach" below.

3.2. Group approach: group-wide rules

The linkage between interest deduction of an entity and the "real" net third party interest expense of its group is an important policy justification for the group-wide rules considered in the Discussion Draft. For instance, the Discussion Draft highlights the importance of this linkage by emphasising that "the *best* measure for total net interest deductions within a group is the group's actual net third party interest expense" (emphasis added).[88] Under these group-wide rules, if a group does not have any net third party interest expense, group members would not be allowed to deduct any net interest expense.[89]

Despite repeated emphasis of the importance of this linkage in the Discussion Draft, it did not appear to be an important consideration in the design of the best practice approach in the Final Report. The issue of "using intragroup loans to generate interest deductions in excess of the group's actual third party interest expenses" was mentioned twice in the Final Report, first in the executive summary as one of the three scenarios in which BEPS risks may arise, and then in the section "Introduction" which stated that

> "there remains a general view that in many cases multinational groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expenses".[90]

However, this issue did not appear again in any other parts of the Final Report, including the discussion of the best practice approach.

The lack of focus on this issue in the Final Report is disappointing. The abandonment of the goal to limit interest deduction to the "real" interest expense of a group may be due partly to the failure to secure enough support from participating countries for the group-wide rules, and partly to the problems encountered in the design of these rules. The following paragraphs analyse the group-wide rules considered in the Discussion Draft.

[87] Final Report, above fn.2, para.22.
[88] Discussion Draft, above fn.5, para.59. Besides this principle, the Discussion Draft also stated that a group-wide rule should work on another basic premise, namely "within a group interest expense should be matched with economic activity": Discussion Draft, above fn.5, para.59.
[89] The operation of the group-wide rule with respect to this issue was illustrated in Example 7 in the Discussion Draft: Discussion Draft, above fn.5, paras 253–257.
[90] Final Report, above fn.2, 11 and para.18.

3.2.1. An application of the enterprise doctrine

As mentioned above, the key advantage of a group-wide rule for anti-BEPS purposes is to link interest deduction of an entity to the actual net interest expense of its group.[91] A group-wide rule is also superior to a fixed ratio rule in the sense that the former

> "has the advantage of tailoring an appropriate [interest deduction] limit for each MNE, thereby avoiding the endemic under-reach and over-reach of a fixed ratio rule".[92]

The following paragraphs analyse two alternative group-wide rules proposed in the Discussion Draft, namely an interest allocation rule and a group ratio rule.[93]

3.2.2. Interest allocation rule

An interest allocation rule represents a direct linkage between the real net third party interest expense of a group and interest deduction of an entity. Under this rule, the net third party interest expense of a group would be allocated to group members according to their respective earnings or assets.[94] The Discussion Draft analysed two variations of the interest allocation rules: 1. a deemed interest rule; and 2. an interest cap rule.[95] In broad terms, under the deemed interest rule, an entity can deduct a deemed amount equal to the allocation of its group's net third party interest expense, regardless of the interest expense incurred by the entity. In contrast, under the interest cap rule, an entity can deduct its interest expense up to the allocation of its group's third party interest expense.

The deemed interest rule has at least two problems. First, the BEPS project revealed that many countries were reluctant to allow deduction of a deemed amount which was not paid by an entity.[96] For instance, a country may resist a policy that allows an entity to deduct an amount of deemed interest expense when the entity is highly profitable and has no debt at all.[97] Secondly,

[91] The Discussion Draft also argued that a group-wide rule has two other advantages. First, it is flexible to cope with the funding position of different groups and thus "should be suitable for groups operating in most sectors, and remain suitable as a group's funding needs change throughout its economic cycle": Discussion Draft, above fn.5, para.61. Secondly, as a group-wide rule focuses on the net interest expense of a group instead of the intra-group debt, it "could reduce the need for transfer pricing rules in this area": Discussion Draft, above fn.5, para.66.

[92] Burnett, above fn.3, 327.

[93] Discussion Draft, above fn.5, para.67. Under both rules, it was proposed that consolidated financial statements prepared under the accounting standards should be used for the purposes of the definition of a group and for determining the values of earnings or assets of a group: Discussion Draft, above fn.5, paras 94 and 101. The primary reasons for the proposal to follow consolidated financial statements prepared under accounting standards are simplicity and the fact that the relevant numbers would have been "subject to independent audit": Discussion Draft, above fn.5, para.101.

[94] Discussion Draft, above fn.5, para.67.

[95] Discussion Draft, above fn.5, para.69. The deemed interest rule may be inspired by a proposal made by Graetz: M. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses" (2008) 62 *Bulletin for International Taxation* 486 (November), 492. Other commentators have proposed similar rules, see for example, J. Vleggeert, "Interest Deduction Based on the Allocation of Worldwide Debt" (2014) 68 *Bulletin for International Taxation* 103 (February); and Burnett, above fn.3.

[96] Discussion Draft, above fn.5, para.75.

[97] When Graetz proposed the deemed interest rule, he argued that "there is no important national competitive advantage available in departing from the solution I have offered here. That alone does not make achieving a multinational solution easy, but it might make it possible": Graetz, above fn.95, 493. Unfortunately, it appeared that many countries that were involved in Action 4 rejected the proposal as they found the policy of allowing deduction of deemed interest

the deemed interest rule may be abused by MNEs to claim double deduction. For instance, it may be possible for a MNE to raise third party debt in a country that has not implemented the deemed interest rule. In that case, the MNE may be able to claim the interest expense twice, first in that country and again in other countries that have adopted the deemed interest rule.[98]

In comparison with the deemed interest rule, the interest cap rule represents a less direct link between interest deduction of an entity and its group's net third party interest expense, as the allocation of the group's net third party interest expense to an entity would be irrelevant if it was more than the interest expense of the entity. Under an interest cap rule, any excess of interest expense of an entity over the allocation of its group's net third party interest expense would be disallowed and might be carried forward to future years.[99] This issue should not be significant in practice, as MNEs are agile and

> "may seek to re-organise their intragroup financing so that the net interest expense in each entity reflects the interest cap allocated to it".[100]

In particular,

> "[academic] research and countries' experience has shown that, following the introduction of rules to limit interest deductions, entities will review and adapt their existing financing arrangements to reduce the impact of these rules".[101]

There is little doubt that MNEs are most likely capable of managing this issue.[102]

Based on the above analysis, countries participating in Action 4 preferred the interest cap rule over the deemed interest rule, and concluded that "if an interest allocation rule is included in a best practice approach … it should be structured as an interest cap rule".[103]

No interest allocation rule was eventually included in the best practice approach in the Final Report as it suffered from a critical problem.[104] The rule would work properly *only if all countries apply the rule consistently*.[105] It is extremely difficult, if not impossible, to achieve international

amount unacceptable. Other commentators have also proposed a similar deemed deduction rule, see for example: Burnett, above fn.3, 328.

[98] Discussion Draft, above fn.5, para.75. This issue was illustrated in Example 4 in Annex 3 of the Discussion Draft.

[99] Discussion Draft, above fn.5, paras 76 and 183.

[100] Discussion Draft, above fn.5, para.76.

[101] Discussion Draft, above fn.5, para.183.

[102] For an illustration of how a MNE can avoid excessive interest expense under the interest cap rule, see: Discussion Draft, above fn.5, Example 3 in Annex 3.

[103] Discussion Draft, above fn.5, para.77.

[104] The Discussion Draft also recognised that compliance and administrative costs might be "higher under a group-wide rule than under a fixed ratio rule based entirely on local entity numbers": Discussion Draft, above fn.5, para.64. However, this concern did not seem to be significant, as these costs "may be relatively low" because most of the required information "can be obtained from consolidated financial statements": Discussion Draft, above fn.5, para.64. Furthermore, additional information may be available with country-by-country reporting as recommended in OECD/G20 Base Erosion and Profit Shifting Project, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD Publishing, 2015): Discussion Draft, above fn.5, para.227. In contrast, some practitioners argued that the application of a group-wide rule would be "an extremely complex exercise": O. Hoor and K. O'Donnell, "BEPS Action 4: When Theory Meets Practice" (2015) 78 *Tax Notes International* 643 (18 May 2015), 646.

[105] Discussion Draft, above fn.5, para.68.

consensus on the adoption of a group-wide rule and the design of its main elements.[106] This is often the Achilles' heel for a strong multilateral application of the enterprise doctrine.[107]

3.2.3. Group ratio rule

In contrast to an interest allocation rule, a group ratio rule represents an indirect linkage between the "real" net third party interest expense of a group and interest deduction of a group member. Under this rule, a financial ratio of an entity—such as net interest-to-earnings—is compared with that of its group for the purpose of determining the amount of deductible interest expense of the entity.[108] Any excess interest expense would be disallowed and may be carried forward to future years.[109]

An important advantage of a group ratio rule over an interest allocation rule is that its operation does not require consistent international application, and therefore can be

> "applied more flexibly, with greater scope for a country to use its own approaches for determining [the main] elements, for example to reflect existing domestic tax principles".[110]

This advantage of flexibility may be a double-edged sword. The Discussion Draft recognised that this flexibility may result in a spectrum of different rules between countries, implying that not only would the compliance costs of MNEs increase,[111] but more importantly, the total interest deductions of group members may exceed the group's net third party interest expense.[112]

The OECD proposed two alternative combined approaches in the Discussion Draft.[113] A detailed discussion of the two alternative combined approaches is beyond the scope of this article. In broad terms, Approach 1 applied a group-wide interest allocation rule as the general rule, with a low fixed ratio rule as the carve out. Approach 2 adopted a low fixed ratio rule as the general rule, with a group ratio rule as the carve out.[114] The Final Report adopts largely Approach 2, as explained in the next section.

[106] D. Duff, "Action 4 of the OECD Action Plan on Base Erosion and Profit Shifting Initiative: Interest and Base-Eroding Payments — Insights from the Canadian Experience" (2015) 69 *Bulletin for International Taxation* 350 (June/July), 350.
[107] For a critical analysis of the original proposal of the EU-wide consolidation regime, see A. Ting, "Multilateral formulary apportionment model — A reality check" (2010) 52(1) *Australian Tax Forum* 95.
[108] Discussion Draft, above fn.5, para.67.
[109] Discussion Draft, above fn.5, para.78.
[110] Discussion Draft, above fn.5, para.68. Another advantage of a group ratio rule is that as group ratios can be "applied directly to the earnings or asset value of an entity in its functional currency … [it] may have advantages for countries with relatively volatile currencies": Discussion Draft, above fn.5, para.87.
[111] Discussion Draft, above fn.5, para.86.
[112] The Discussion Draft stated that a spectrum of different group ratio rules "may create opportunities for [BEPS] where total net [interest] deductions available *exceed* the group's actual net third party interest expense" (emphasis added): Discussion Draft, above fn.5, para.86.
[113] Discussion Draft, above fn.5, Ch.X.
[114] It is unclear whether this role of the group ratio rule was influenced by the finding that, after studying the existing group ratio rules in countries such as Australia, France, Germany and New Zealand, "the group ratio rule generally *does not operate to limit interest deduction*, but instead operates as a carve-out which *allows companies to escape application of a main fixed ratio rule*" (emphasis added): Discussion Draft, above fn.5, para.81; and Final Report, above fn.2, para.118. For a discussion of the German group ratio rule, see for example: Burnett (2014), above fn.55, 50–51.

4. The best practice approach

This section reviews the best practice approach recommended in the Final Report and, using Chevron as a case study, evaluates whether it is effective for combating BEPS using interest deduction. Before proceeding, it is important to note that the adoption of a best practice approach is optional for countries,[115] and represents a relatively weak consensus among participating countries in comparison to, for example, a new minimum standard which has to be implemented by all countries.[116] The OECD's expectation is that the best practice approach on Action 4 may "facilitate the convergence of national practices by interested countries" and thus may set the stage for a minimum standard in future.[117]

After the extensive analysis and consultation of alternative interest limitation rules, the OECD recommended a best practice approach as summarised below, which—in addition to the fact that the adoption of a best practice approach is itself optional for countries—consists of many optional policies which do not always align with its own analysis[118]:

1. an earnings-based fixed ratio rule: under this rule, an entity can deduct net interest expense up to a benchmark net interest-to-tax EBITDA ratio.[119] Countries are allowed the option to choose a benchmark ratio between 10 and 30 per cent. Furthermore, countries can choose to use EBIT instead of EBITDA, or even a fixed ratio rule based on asset values instead of earnings.[120] This is despite the fact that the OECD's own analysis concluded that earnings was the preferred basis over asset values for a fixed ratio rule[121];
2. an earnings-based group ratio rule[122]: the role of this rule in the best practice approach is to allow an entity to deduct more interest expense than that allowed under the fixed ratio rule. In particular, this rule allows an entity to deduct net

[115] Countries are allowed to apply rules that are stricter than the best practice approach: Final Report, above fn.2, para.31.

[116] There are in general four categories of recommendations for the various BEPS Action items, namely and, in order of decreasing commitment of the participating countries, new minimum standard, revision of an existing standard, common approach, and best practice: Greenwoods Herbert Smith Freehills, above fn.9.

[117] OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement—2015 Final Reports* (2015), available at: *https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf* [Accessed 20 January 2017], paras 11 and 18.

[118] Final Report, above fn.2, para.22. This best practice approach was largely the "combined approach 2" proposed in the Discussion Draft, above fn.5. This approach was the preferred option of the business community, which had successfully objected to the alternative combined approach which would apply a group-wide allocation of a group's net third party interest expense: M. Graetz, *Follow the Money — Essays on International Taxation* (Lillian Goldman Law Library at Yale Law School, 2016), 272; and Burnett, above fn.3, 327.

[119] Final Report, above fn.2, Ch.6. The best practice approach recommends that the fixed ratio rule should use EBITDA determined under tax law, instead of accounting rules. In particular, for the purposes of the fixed ratio rule, an entity's EBITDA should be defined as its taxable income subject to the following adjustments: 1. adding back the tax values of net interest expense, depreciation and amortisation; and 2. deducting any tax exempt income of the entity: Final Report, above fn.2, para.89.

[120] Final Report, above fn.2, para.23.

[121] Discussion Draft, above fn.5, paras 120–128.

[122] The OECD has continued its work on the detailed technical design of the group ratio rule. The Discussion Draft on this issue was released by the OECD in July 2016: OECD, *Public Discussion Draft—BEPS Action 4—Elements of the Design and Operation of the Group Ratio Rule* (Discussion Draft — Group Ratio Rule) (11 July 2016), available at: *https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-elements-of-the-design-of-group-ratio-rule.pdf* [Accessed 20 January 2017].

interest expense up to its group's net interest-to-EBITDA ratio.[123] In addition to the option of an uplift to a group's net third party interest expense of 10 per cent, the best practice approach permits two more options with respect to this rule. First, a country may opt to apply a different group ratio rule. Secondly, a country may even opt to have no group ratio rule at all;

3. an optional rule to carry forward disallowed interest or unused interest capacity and/or carry back of disallowed interest;
4. a de minimis monetary threshold for low risk entities: this recommendation is also subject to an option. Instead of a monetary threshold, countries may opt for a threshold based on net interest expense of the local group;
5. targeted rules: the aim of these rules is to protect the general rules and to address specific BEPS risks[124]; and
6. specific rules for banking and insurance sectors.[125]

The best practice approach may represent the best possible consensus that could be achieved among participating countries within the tight timeframe of the BEPS project. However, it encounters important problems which cast doubt on its effectiveness in combating BEPS using interest deduction.

4.1. Allowing interest deduction exceeding net third party interest expense

The first problem with the best practice approach is its failure to achieve a key objective of Action 4, namely, to prevent a MNE from claiming interest deduction in excess of its net third party interest expense. The OECD indirectly admitted this issue by omitting this policy in its justification for the inclusion of a fixed ratio rule and a group ratio rule in the best practice approach.[126]

This problem can be illustrated through the case study of Chevron. The estimated maximum amounts of interest deduction that would have been allowed if Australia had introduced the recommended fixed ratio rule in the relevant years are shown in the following table:

	2011	**2012**	**2013**	**2014**
CAH:				
Interest payments on intra-group debt[127]	*AUD $0.7B*	*AUD $1B*	*AUD $1.3B*	*AUD $1.8B*
EBITDA[128]	AUD $3.2B	AUD $4.6B	AUD $1.9B	AUD $1.7B
Interest limitation @ 30%	*AUD $1.0B*	*AUD $1.4B*	*AUD $0.5B*	*AUD $0.5B*

[123] Final Report, above fn.2, Ch.7.
[124] Final Report, above fn.2, Ch.9. For a discussion of these rules, see section "Targeted rules" below.
[125] The Discussion Draft on the detailed technical design of the specific rules for banking and insurance industries was released by the OECD in July 2016: OECD, *Public Discussion Draft—BEPS Action 4—Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors* (28 July 2016), available at: *http://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf* [Accessed 20 January 2017].
[126] Final Report, above fn.2, paras 23–25.
[127] Chevron Submission 121, above fn.37, 8.
[128] As the relevant tax numbers of CAH are not available to the public, these EBITDA amounts are calculated based on accounting numbers extracted from CAH's consolidated financial statements for the respective years.

	2011	**2012**	**2013**	**2014**
Chevron group:				
Interest expense per Income Statement[129]	US $0	US $0	US $0	US $0
Capitalised interest[130]	US $288M	US $242M	US $284M	US $358M
- equivalent AUD $ (@ 1.2 exchange rate)	AUD $0.3B	AUD $0.3B	AUD $0.3B	AUD $0.4B

Two observations can be made from the table above. First, the fixed ratio rule would have allowed interest deductions in excess of the group's net third party interest expense for all four years. This is the case even if capitalised interest was taken into account. Secondly, this case study suggests that the fixed ratio rule would have been more effective as an anti-BEPS regime than the existing thin capitalisation rule in Australia. In contrast to the fact that CAH was not caught by the thin capitalisation regime for all the relevant years, the fixed ratio rule would have disallowed substantial interest deductions in 2013 and 2014.[131]

The role of the group ratio rule as a carve out, instead of as a cap, in the best practice approach may represent a missed opportunity for the OECD. The following table demonstrates the impact of a group ratio rule that serves to *cap* interest deduction of CAH:

	2011	**2012**	**2013**	**2014**
CAH:				
Interest payments on intra-group debt[132]	*AUD $0.7B*	*AUD $1B*	*AUD $1.3B*	*AUD $1.8B*
EBITDA[133]	AUD $3.2B	AUD $4.6B	AUD $1.9B	AUD $1.7B
Chevron group:				
Interest expense per Income Statement[134]	US $0	US $0	US $0	US $0
Capitalised interest[135]	US $288M	US $242M	US $284M	US $358M
EBITDA[136]	US $34.7B	US $32.9B	US $21.7B	US $14.4B
Group ratio: interest (capitalised)/EBITDA	0.008	0.007	0.013	0.025
Interest limitation (based on interest expense per Income Statement)	*AUD $0*	*AUD $0*	*AUD $0*	*AUD $0*
Interest limitation (based on capitalised interest)	*AUD $0.03B*	*AUD $0.03B*	*AUD $0.02B*	*AUD $0.04B*

[129] Chevron Annual Reports, above fn.47, p.4 of the respective reports for 2011–2014.
[130] Chevron Annual Reports, above fn.47, Notes 24 and Note 25 to the 2013 and 2014 Consolidated Financial Statements respectively.
[131] The group ratio rule as suggested in the best practice approach would not help Chevron, as its group ratios were minimal for those two years.
[132] Chevron Submission 121, above fn.37, 8.
[133] As the relevant tax numbers of CAH are not available to the public, these EBITDA amounts are calculated based on accounting numbers extracted from CAH's consolidated financial statements for the respective years.
[134] Chevron Annual Reports, above fn.47, p.4 of the respective reports for 2011 to 2014.
[135] Chevron Annual Reports, above fn.47, Notes 24 and Note 25 to the 2013 and 2014 Consolidated Financial Statements respectively.
[136] Chevron Annual Reports, above fn.47, for 2011 to 2014, Consolidated Statements of Income.

At the time of writing this article, the OECD is working on the detailed design of the group ratio rule, including the definition of "net third party interest expense".[137] The alternative definitions being considered include: 1. interest expense figure taken from consolidated income statement without adjustment[138]; and 2. that figure but adjusted to include, among other things, capitalised interest.[139] The table above shows that if a group ratio rule adopts the interest expense figures in Chevron's consolidated income statements without adjustment, all of CAH's interest expense would be disallowed. Even if the group ratio rule adopts the second definition and includes capitalised interest in the calculation of the interest limitation, CAH's interest deduction would still be significantly limited for all four years.

The group ratio rule as recommended in the best practice approach also fails to prevent a MNE from claiming interest deduction in excess of its net third party interest expense. While the OECD recognised that the group ratio rule allowed a MNE to claim interest deduction up to its net third party interest expense,[140] it fell short of ensuring that the MNE could not claim more interest deduction. In fact, in its analysis of the possible treatments of loss-making entities for the purposes of the group ratio rule, the OECD admitted that the risk of claiming interest deduction in excess of net third party interest expense could be dealt with only "in part".[141]

4.2. Generous benchmark fixed ratio

The second problem of the best practice approach stems from the recommended benchmark fixed ratio. The OECD appeared to have changed its mind with respect to the benchmark fixed ratio between the Discussion Draft and the Final report. The Discussion Draft emphasised that, for anti-BEPS purposes, the ratio "should … be at a level that is *lower* than currently applied in many countries" (emphasis added) if it was used as a general rule.[142] This emphasis on a low benchmark fixed ratio was reiterated in the Final Report in its discussion of the best practice approach (emphasis added)[143]:

> "… the benchmark fixed ratio *can be kept low, in particular for entities in large multinational groups*, making sure the fixed ratio rule is effective in combating base erosion and profit shifting, while the group ratio rule compensates for the blunt operation of such a rule".

As the empirical analysis in both the Discussion Draft and the Final Report shows that the majority of large MNEs have a very low level of, or even no, net third party interest expense, it seems reasonable for the OECD to recommend that, as a general rule, the fixed ratio should be set at *lower than* 30 per cent.[144] In fact, the OECD's own analysis demonstrated clearly that a

[137] Discussion Draft — Group Ratio Rule, above fn.122.
[138] Discussion Draft — Group Ratio Rule, above fn.122, para.6.
[139] Discussion Draft — Group Ratio Rule, above fn.122, para.13.
[140] Final Report, above fn.2, para.150.
[141] Final Report, above fn.2, para.151. Ironically, both examples in the Final Report regarding the issues of loss-making entities demonstrate clearly that under the best practice approach, a MNE could still claim more interest deductions than its "real" interest expense: Final Report, above fn.2, paras 151 and 152, and Examples 9b and 9c.
[142] Discussion Draft, above fn.5, paras 168 and 170.
[143] Final Report, above fn.2, para.115. In fact, the OECD repeatedly emphasised in the Final Report that in most cases, the benchmark fixed ratio should be "kept low": see for example, Final Report, above fn.2, paras 25 and 115.
[144] This is especially so given the group ratio rule as recommended in the best practice approach would serve as a carve out for MNEs with higher gearing ratios.

benchmark ratio of 30 per cent was too high and many MNEs can claim interest deductions well in excess of their net third party interest expense.[145] It is unclear why the best practice approach allows countries to select up to this level.

It is interesting to note that in an example designed to illustrate the factors that countries should consider in setting the benchmark ratio, it seems to suggest that a country should adopt a 30 per cent benchmark ratio only if, among other things, it has "other tax rules that tackle *all of the issues to be addressed under Action 4*" (emphasis added).[146] This position begs the question why a country would still need a fixed ratio rule if it has already implemented other rules to address *all* issues arising from interest deduction.

As mentioned above, the OECD explicitly stated that a country

> "should not apply a higher ratio due to a policy of attracting international investment into a country through lenient interest limitation rules".[147]

It is unclear how this plea would be received by countries. Experience so far suggests that countries may be inclined to adopt the maximum 30 per cent benchmark ratio allowed in the best practice approach. For instance, the UK Government has proposed that it reform its interest limitation regime, consisting of a fixed ratio rule with a 30 per cent benchmark ratio.[148] The European Council also adopted a new directive to address corporate tax avoidance in July 2016, including a fixed ratio rule with a 30 per cent benchmark ratio.[149]

5. Targeted rules

The OECD's analysis of targeted rules with respect to intra-group debt is of particular interest. Targeted rules are defined in general to be "any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements".[150] The role of targeted rules is to address specific BEPS risks that the general rules recommended by the OECD—namely, the fixed ratio rule and the group ratio rule—fail to address.[151] In both the Discussion Draft and the Final Report, the OECD listed a number of targeted rules that countries may consider adopting, including rules targeting intra-group debt, artificial debt not raising additional funding for the borrower, and routing funding through intermediate entities for tax avoidance purposes.[152]

In comparison with the Final Report, the analysis of targeted rules for intra-group debt in the Discussion Draft was not only more detailed, but also appeared to be the first example of targeted rules, suggesting that these types of rules might be regarded as relatively important as compared

[145] Final Report, above fn.2, para.18. The experience with the 30% benchmark ratio in Germany also suggested that it was too generous: L. Sheppard, "BEPS Interest Deduction Guidance Coming", *World Tax Daily*, 2 March 2015.
[146] Final Report, above fn.2, para.253 in Example 5.
[147] Final Report, above fn.2, para.109.
[148] HM Treasury and HM Revenue & Customs, above fn.61, para.5.1.
[149] Council of the European Union, *COUNCIL DIRECTIVE laying down rules against tax avoidance practices that directly affect the functioning of the internal market* (July 2016), available at: *http://data.consilium.europa.eu/doc/document/ST-10539-2016-COR-1/en/pdf* [Accessed 23 January 2017], Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1 art.4(1).
[150] Final Report, above fn.2, para.168.
[151] Final Report, above fn.2, para.168.
[152] Discussion Draft, above fn.5, para.181.

to other targeted rules. In particular, the Discussion Draft stated explicitly that if the general rules failed to address risks posed by intra-group and related party debt, these risks could be dealt with through targeted rules that either[153]:

> "(i) disallow all interest payments to connected and related parties;[154] (ii) allow tax deductions for [such] interest … subject to a condition that the recipient is subject to a minimum level of taxation on the receipt …"[155]

However, these targeted rules received quite different treatment in the Final Report. The policy option of outright disallowance was absent in the Final Report. Furthermore, the Final Report limited the scope of the second policy option to interest paid to a "related party", which was defined specifically to exclude interest expense on intra-group debt. In particular, "two persons … are related if *they are not in the same group* but they meet any of the following conditions …" (emphasis added).[156] It is unclear why the OECD imposes this limited scope for targeted rules in the Final Report.

Furthermore, there is no detailed discussion of the various forms of possible targeted rules in either the Discussion Draft or the Final Report. It is unclear why the OECD did not analyse these rules in more detail. This is particularly puzzling when the OECD admitted repeatedly that targeted rules would be necessary not only to address BEPS risks posed by entities not subject to the general rules, but also to cover specific BEPS risks that remain even where the general rules apply.[157] The OECD has also emphasised the importance of targeted rules with respect to the setting of the benchmark fixed ratio within its recommended corridor of 10 to 30 per cent. In particular, a country may apply

> "a higher benchmark fixed ratio if it applies other targeted rules that specifically address the base erosion and profit shifting risks to be dealt with under Action 4".[158]

If we accept the argument that the general rules recommended in the Final Report are unlikely to achieve the key objective of preventing interest deductions in excess of a group's net third party interest expense, the role of targeted rules becomes critical if a country is determined to combat BEPS arising from interest deduction. This article does not intend to provide a comprehensive analysis of the design and operation of alternative targeted rules, or to recommend any particular forms of the rules. Nevertheless, the following section reviews the targeted rule

[153] Discussion Draft, above fn.5, para.181.
[154] The outright disallowance of intra-group interest expense may be supported by the argument that intra-group debt is economically equivalent to equity, and therefore should not be deductible: see for example, Vann and Burnett, above fn.55, 236. The policy of outright disallowance of intra-group interest expense may appear to be unusual for tax law. However, accounting rules have the longstanding tradition of disregarding intra-group debt which is "essentially unreal": L. Sheppard, "U.S. Goes After Earnings Stripping, Hits Cash Management" (2016) 82 *Tax Notes International* 215 (dated 18 April 2016), 216.
[155] Discussion Draft, above fn.5, para.181. For examples of these kinds of targeted rules, see Traversa, above fn.6, fn.39.
[156] Final Report, above fn.2, para.176. Other differences with respect to targeted rules between the Discussion Draft, above fn.5, and the Final Report include the addition of examples of targeted rules in the Final Report to protect the recommended general rules and to combat artificial interest payments aiming to reduce net interest income of an entity: Final Report, above fn.2, paras 171 and 173.
[157] Final Report, above fn.2, paras 169 and 173.
[158] Final Report, above fn.2, para.99.

adopted in Sweden, aiming to provide some insights into the design of this kind of anti-BEPS rule.

Targeted rule in Sweden[159]

The interest limitation regime in Sweden is a targeted rule focusing on intra-group debt. The regime was introduced in 2009 and amended to its current form in 2013. It is interesting to note that the regime has been described by tax professionals as "effectively preventing base erosion through interest deductions", though in the same breath they warned other countries against adopting similar rules.[160]

In general, the Swedish regime applies an outright disallowance rule under which interest expense on intra-group debt is not deductible.[161] This strict rule is subject to two main exceptions. In general, the first exception applies if the corresponding interest income is subject to taxation in the hands of the receiving entity at an effective tax rate of at least 10 per cent, and the main purpose of the intra-group debt is not for the group to obtain a tax benefit. The second exception applies if a taxpayer can prove that the intra-group debt is mainly motivated by business reasons and the lender is a resident within the European Economic Area (EEA) or a tax treaty country with Sweden.

The regime has been subject to challenge by the European Commission, which issued a letter of formal notice to Sweden in November 2014, alleging that the regime restricts the freedom of establishment without sufficient justification or in a disproportionate manner.[162] While Sweden has formally responded to the notice rejecting the allegation,[163] it has been reported that the country is considering amending or even replacing the regime with other interest limitation regimes.[164]

One of the key reasons for the proposed change of the current regime is that its operation has created significant uncertainty in practice with respect to the deductibility of interest expense of an entity. The uncertainty stems primarily from a couple of "purpose" tests embedded in the regime, including: 1. for the first exception, whether an intra-group debt was created with a main

[159] As the legislation of Sweden and many relevant documents were not in English, the description of the Swedish regime in this section is drawn largely from various articles, including: H. Abdali and T. Fredriksson, "Swedish interest deductibility: unilateral action proposed", *International Tax Review*, 11 May 2015; Douma, above fn.14, 365; and A. Hanko Farago, "Sweden — Reaction to the Final OECD BEPS Package" (2016) 23(3) *International Transfer Pricing Journal*, s.2.2.

[160] Abdali and Fredriksson, above fn.159.

[161] For a discussion of the definition of a group for the purpose of this regime, see: B. Nikou, *The Swedish Interest Deduction Limitation Rules — To Be Or Not To Be?* (2015), Master Thesis in European and International Tax Law, Lund University, available at: *http://lup.lub.lu.se/luur/download?func=downloadFile&recordOId=8171620&fileOId=8171631* [Accessed 23 January 2017], 9.

[162] A detailed discussion of the issues arising from the EC challenge is beyond the scope of this article. For a discussion of the rationale of the EC, see for example Douma, above fn.14, 365.

[163] See for example: KPMG, "Sweden's response to the European Commission on interest deductions" (2015) (2) *Tax News* (24 February 2015), available at: *https://assets.kpmg.com/content/dam/kpmg/pdf/2015/02/TaxNews-eng-issue2-2015-Sweden%E2%80%99s-response-to-the-European-Commission-on-interest-deductions.pdf* [Accessed 23 January 2017].

[164] Abdali and Fredriksson, above fn.159. The Swedish Committee on Corporate Taxation proposed reform options in 2014: Hanko Farago, above fn.159, s.2.2. For a discussion of the proposal, see: Melz, above fn.62.

purpose to obtain tax benefit; and 2. for the second exception, whether the main purpose of an intra-group debt is for business reasons.[165]

A couple of lessons may be learnt from the experience of the targeted rule in Sweden. First, a general rule to disallow intra-group interest expense may be an effective anti-BEPS measure, as it effectively removes the tax incentive for a group to create artificial interest expense between group members. This policy addresses a fundamental problem of the existing international tax regime: it generally recognises and respects intra-group arrangements even if they are entered into primarily for tax avoidance purposes. Secondly, an interest limitation regime has to be relatively certain in the sense that taxpayers should be able to determine with relative ease whether or not they would be caught by the rules. In particular, it may not be appropriate to apply a purpose test in an interest limitation regime which has a wide scope of application to a large number of taxpayers.

6. Conclusion

The two tax structures of Chevron highlight the importance of an interest limitation regime in practice as the first line of defence against BEPS using intra-group debts. The existing thin capitalisation regime in Australia has proved incapable of preventing Chevron from claiming interest deduction in excess of the group's net third party interest expense.

The OECD commenced its work on Action 4 with the aim of achieving international consensus on interest limitation regimes that could, among other things, prevent MNEs from claiming interest deductions in excess of their real net third party interest expense. While in theory a group-wide interest allocation regime—which represents a relatively strong application of the enterprise doctrine—would be capable of achieving this policy objective, the experience of the BEPS project suggests that in practice it is very difficult, if not impossible, to achieve international consensus on this multilateral regime.

The best practice approach recommended in the Final Report is a step in the right direction, and the OECD should be commended for accomplishing its work on this challenging issue. The case study on Chevron suggests that for anti-BEPS purposes, an interest-to-EBITDA fixed ratio rule may be more effective than some of the existing interest limitation regimes, including the thin capitalisation regime in Australia. The best practice approach may also provide a strong basis for governments to promote and defend their proposals to introduce more effective interest limitation regimes. This is important as these reform proposals are often met with strong opposition from the business community.

Nevertheless, the interest-to-EBITDA fixed ratio rule does not have any link to a group's net third party interest expense, and thus cannot prevent a group from claiming interest deduction in excess of its "real" interest expense. The Chevron case study shows that a group ratio rule—which represents an indirect link with a group's net third party interest expense—is likely to be more effective in addressing this issue, provided that the rule serves to *cap* interest deduction.

[165] The issue of certainty was also exacerbated by the fact that the Supreme Administrative Court of Sweden has ruled that the interest limitation regime was not an appropriate regime for advance tax rulings: Abdali and Fredriksson, above fn.159. In other words, taxpayers could no longer rely on the advance tax ruling system to ascertain whether their interest expenses are deductible or not under the regime.

It may be a missed opportunity that the best practice approach in the Final Report uses a group ratio rule instead as a carve out for a fixed ratio rule, thus negating its anti-BEPS potential.

Besides a group ratio rule, targeted rules may also provide much food for thought in the design of an interest limitation regime. This is an area for future research, and a story for another day.

Australia; Base erosion and profit shifting; Multinational companies; OECD; Tax avoidance; Thin capitalisation; Transfer pricing