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

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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 Base Erosion and Profit Shifting ("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.

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, nor 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]

[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)), at 7.

[2] OECD, *OECD/G20 Base Erosion and Profit Shifting Project – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report* ("Final Report"), at 15.

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

[4] United Nations, "Limiting Interest Deductions" (2014), paper prepared by Peter Barnes in *Papers on Selected Topics in Protecting the Tax Base of Developing Countries*, at 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, paragraph 64.

> 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.[7] 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.

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[5] OECD, *Public Discussion Draft – BEPS Action 4: Interest Deductions and Other Financial Payments* ("Discussion Draft") (available at http://www.oecd.org/tax/aggressive/discussion-draft-action-4-interest-deductions.htm), paragraph 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), 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.

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

[7] The lack of real world examples of this kind of tax avoidance structures was highlighted in a report of the Senate Committee, which stated that "one of the frustration for the committee was the very limited information that was publicly available which outlined 'real world' examples of aggressive tax minimisation using debt-related deductions in an Australian context. Hence, it was difficult for the committee to get an appreciation for the size and scope of this problem": The Senate Economics Reference Committee, *Corporate tax avoidance – Part II : Gaming the system* (2016) (available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Report_part_2), paragraph 2.43.

The aim of this article is twofold. First, it analyses two tax structures of 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 Australia.[8] The second tax structure has been in place from 2010 and was revealed in the Senate enquiry into corporate tax avoidance in Australia.[9] Second, 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.[10] Second, 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,[11] Action 3 on CFC regimes and Action 9 on transfer pricing issues regarding risks and capital.[12] Third, detailed

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

[9] Documents of this enquiry are available at: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance.

[10] For a good summary of the transfer pricing issues in the *Chevron* case, see Richard Vann and Graeme 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). See also: Greenwoods Herbert Smith Freehills, "Tax Brief: The Chevron transfer pricing case – the story so far", dated 5 November 2015 (available at http://www.greenwoods.com.au/media/1721/new-tb-re-chevron-dated-5-november-2015.pdf).

[11] 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, *OECD/G20 Base Erosion and Profit Shifting Project – Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report*, paragraph 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.

[12] For a discussion of the interactions between Action 4 and other Action items, see: Discussion Draft, Chapter 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, at 15.

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.[13] Fourth, specific issues in respect of financial institutions are not discussed in detail in this article.[14]

2. Chevron – a case study

2.1 Tax structure from 2004 to 2009[15]

The *Chevron* tax case was the first transfer pricing case on the issue of "arm's length interest rate" in Australia.[16] This case was complex and expensive to run.[17] The court hearing lasted 5 weeks, which is "almost unprecedented in Australian tax litigation".[18]

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. Furthermore, Chevron's tax structure discussed below represents a snapshot in time, and has

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

[14] For a discussion of the specific issues for banking and insurance groups, see: Final Report, Chapter 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 has been released by the OECD on 28 July 2016 (available at http://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf)

[15] The *Chevron* tax case covered the period from 2004 to 2008. However, the tax structure was in place until it was replaced by the new structure in 2010.

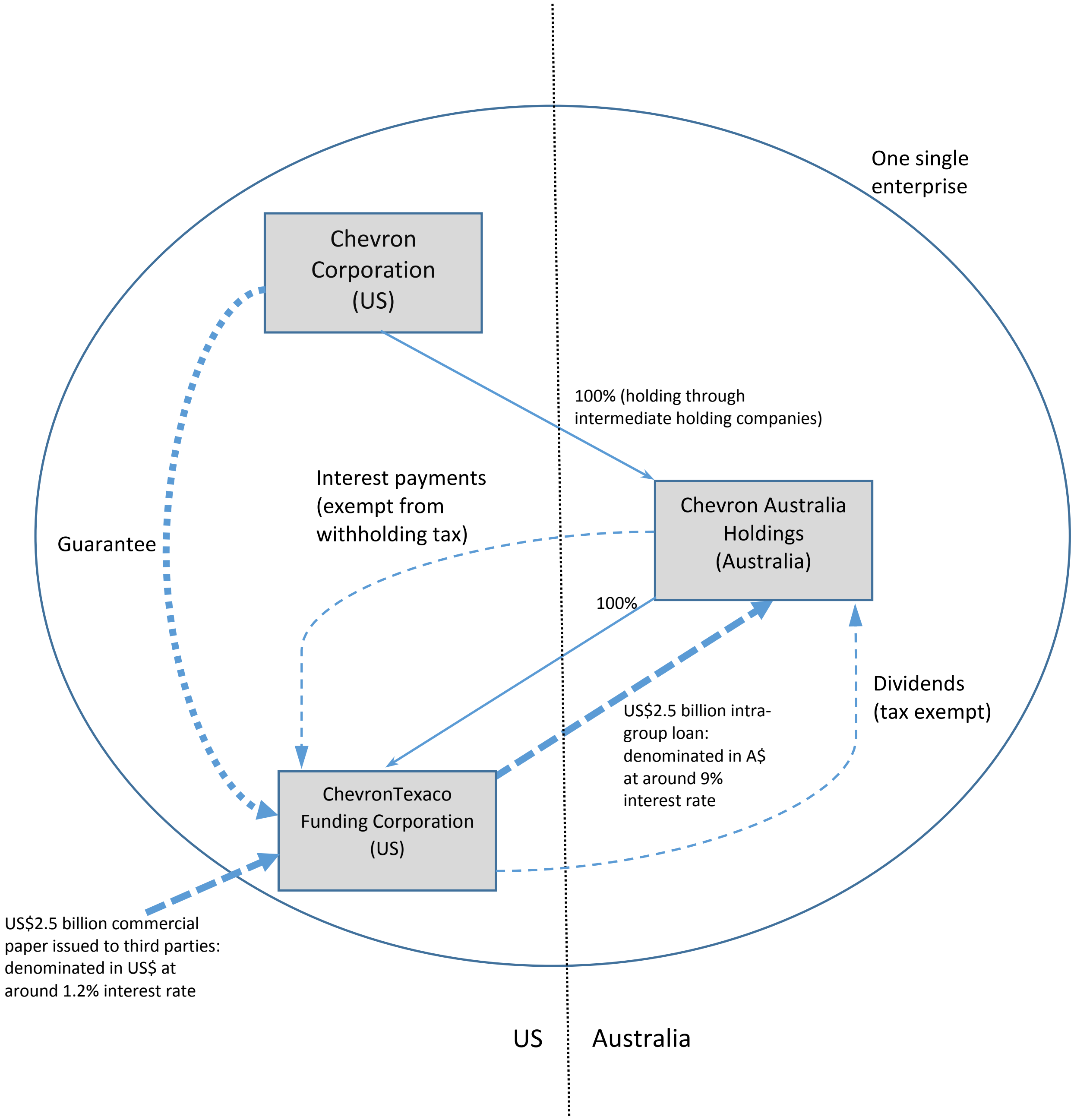
[16] The issue of determining arm's length interest rate has been the main point of argument of other overseas cases, for example, see the analysis for two cases in Finland and Sweden in 2010: Marjaana Helminen, "Determining the Arm's Length Interest Rate of an Intra-Group Loan" (2011) *European Taxation*, April, 153. 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 Australian'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.

[17] The case involved eleven barristers, including 5 Queen's Counsel and Senior Counsel. The legal costs for the ATO was around A$10 million. Chevron has not disclosed its legal costs, but many commentators believed the amount to be at least of the 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": Chloe Burnett, "Interest Deductions and Multinational Enterprises: Goldilocks and the Brave New World" (2015) *Bulletin for International Taxation*, June/July, 326, at 332. The ATO has won the case at first instance, but Chevron has appealed to the Full Federal Court.

[18] Vann and Cooper, above fn. 9, at 1.

evolved over time.[19] 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 the following diagram:



[19] See Section "Tax structure from 2010" below.

Under the structure, Chevron Australia Holdings Pty Ltd ("CAH") established a wholly owned subsidiary in Delaware in the US, ChevronTexaco Funding Corporation ("CFC"). This subsidiary had no employee.[20] It was a special purpose vehicle whose only activity was to issue commercial paper denominated in US dollars to raise US$2.5 billion.[21] It was able to raise the money for an interest rate of around 1.2 per cent[22] due to the guarantee provided by the ultimate parent company Chevron Corporation.[23]

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 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.[24] Second, despite the interest rate on the commercial papers was around 1.2 per cent, CFC charged around 9 per cent interest rate on the intra-group debt.[25] Third, though Chevron Corporation provided a guarantee to CFC's commercial paper, the intra-group debt did not have any security or operational and financial covenants.[26]

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 A$1.5 billion from 2004 to 2008[27] – were exempt from withholding tax in Australia pursuant to a specific exemption for

[20] The *Chevron* case, paragraph 119.

[21] The *Chevron* case, paragraph 107.

[22] Commissioner of Taxation, "Respondent's outline of submissions" ("ATO Submissions"), (Federal Court of Australia File number: NSD440/2013), paragraph 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 2015 Annual Report, Note 19.

[23] The *Chevron* case, paragraph 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": The *Chevron* case, paragraph 145.

[24] The *Chevron* case, paragraph 268. The court hearing also revealed that "88% of [CAH]'s … revenues were in US dollars": The *Chevron* case, paragraph 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), paragraph 56.

[25] ATO Submissions, paragraph 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%: The *Chevron* case, paragraph 2.

[26] The *Chevron* case, paragraph 87.

[27] ATO Submissions, paragraph 69.

public offers.[28] 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.[29] 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 and the corresponding interest income of CFC were offset with each other for US tax purposes.

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.[30] The dividends were exempt from tax under the participation exemption provision in Australia.[31]

The ATO challenged the structure, and issued assessments based on an interest rate of around 5 per cent.[32] The court rejected the taxpayer's appeal on the basis that Chevron failed to satisfy its onus to prove that the assessments were excessive.[33] 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

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[28] Section 128F, Income Tax Assessment Act 1936 ("ITAA 1936"). 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: s.128F(8) ITAA 1936. 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. Second, 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": s.128(8) ITAA 1936. 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.

[29] ATO Submissions, paragraph 73.

[30] ATO Submissions, paragraph 71. The total amount of dividends from 2004 to 2008 was about A$1.1 billion.

[31] ATO Submissions, paragraph 8.

[32] 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: Damian Preshaw, "Transfer pricing and the Chevron case", paper presented at the 31st National Convention of the Tax Institute (available at http://www.taxinstitute.com.au/ticonventionpresentation/transfer-pricing-and-the-chevron-case-presentation), at 4.

[33] As this article's focus is on interest limitation regimes, the transfer pricing issues involved in the case are not discussed in detail. The *Chevron* case highlights a key issue of relying on transfer pricing rules to resolve BEPS by interest deduction, namely the significant difficulty to ascertain the elusive "arm's length" interest rate. In particular, the ATO put forward 6 different possible "arm's length" interest rates in its arguments: The *Chevron* case, paragraph 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, at 8-17.

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 this kind of tax avoidance structures – was proved to be ineffective. CAH had no problem satisfying the requirements in the regime.[34]

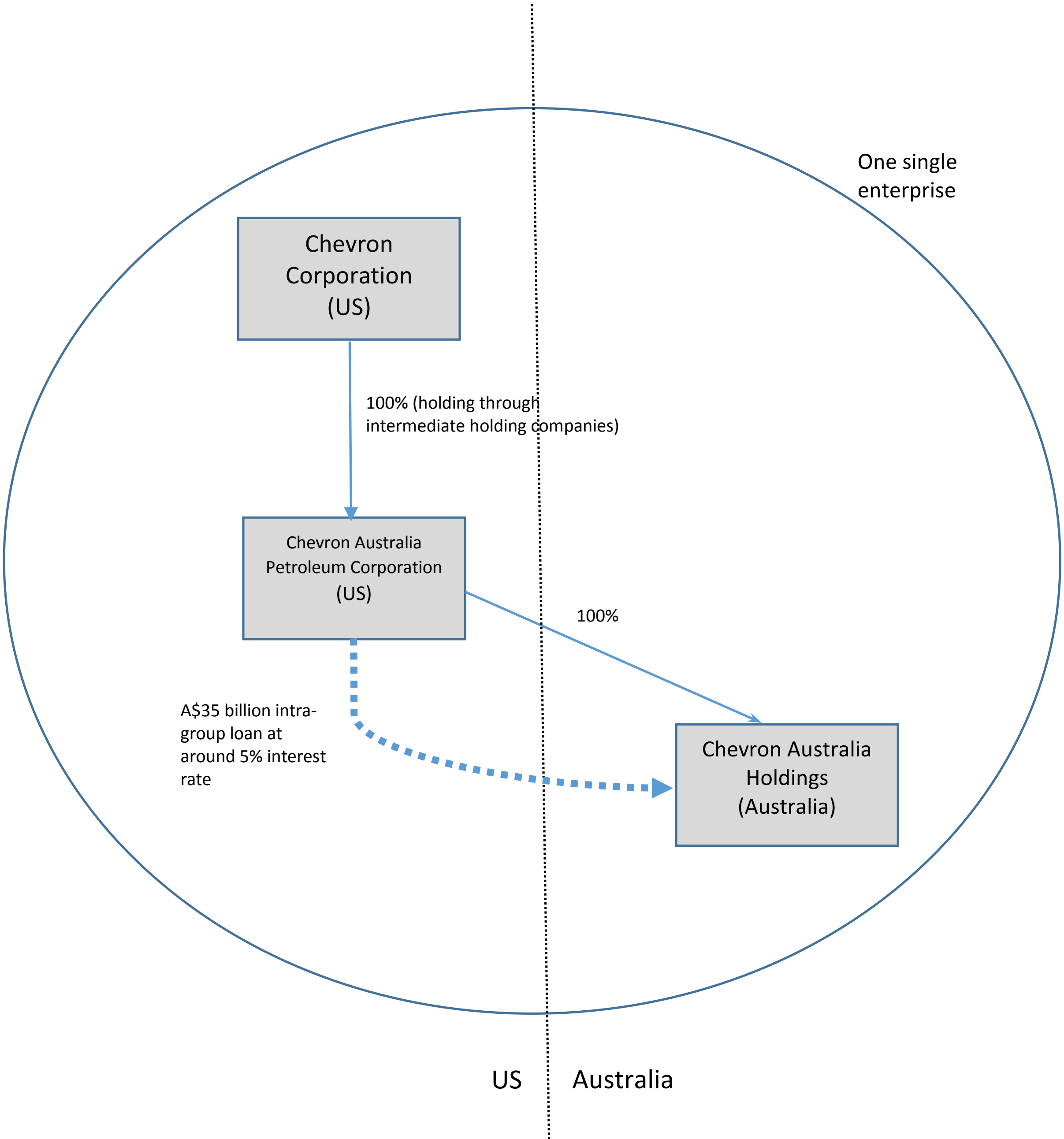
2.2 Tax structure from 2010

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.[35]

[34] The *Chevron* case, paragraph 592.

[35] 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); and Chevron's submission to the Senate enquiry, Submission 121, dated 30 July 2015 (available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions), at 7. The reasons for the change of Chevron's tax structure was 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 A$35 billion under the new structure was significantly more than the US$2.5 billion intra-group debt under the old structure.

The tax structure of Chevron from 2010 is depicted in the diagram below:[36]



[36] The diagram is prepared based on information disclosed in: Chevron, Submission dated 30 July 2015 to the Senate enquiry into corporate tax avoidance, Submission no. 121 ("Chevron Submission 121") (available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions).

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 the more complex structure with 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.[37]

On the other hand, the new structure involves much more significant amounts than that of the old one. The intra-group debt under the new structure is A$35 billion[38] and the interest expenses on the debt for 2014, one single year alone, amounted to A$1.84 billion.[39] 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.[40]

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.[41]

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:[42]

> 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,

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[37] CAH Financial Statements for the Year Ended 31 December 2014, note 17 to the financial statements.

[38] CAH Financial Statements for the Year Ended 31 December 2014, note 17 to the financial statements.

[39] Chevron Submission 121, at 8.

[40] Chevron Corporation 2014 Annual Report, at 4. This issue is discussed in more detail in the next section.

[41] Chevron Submission 121, at 8.

[42] 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), at 5.

Chevron emphasised that CAH's "debt levels complied with the thin capitalisation rules for all relevant years".[43]

The following section provides a summary of the financial positions of 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[44]	**A$0.7B**	**A$1B**	**A$1.3B**	**A$1.8B**
Chevron group:				
Interest expense per Income Statement[45]	**US$0**	**US$0**	**US$0**	**US$0**
Capitalised interest[46]	US$288M	US$242M	US$284M	US$358M
- equivalent A$ (@ 1.2 exchange rate)	**A$0.3B**	**A$0.3B**	**A$0.3B**	**A$0.4B**

[43] Chevron Australia, Submission 121 to the Senate enquiry into corporate tax avoidance (available at http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions), at 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 the *Chevron* case 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 the *Chevron* case accepted that the intra-group debt under the old structure was denominated in A$ 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 case, paragraph 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%. Second, the judge appears 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 case, paragraph 604. See also Greenwoods Herbert Smith Freehills, above fn. 9, at 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.

[44] Chevron Submission 121, at 8.

[45] Chevron Annual Reports (available at http://www.chevron.com/investors/financial-information), at page 4 of the respective reports for 2011 to 2014.

[46] Chevron Annual Reports, Notes 24 and Note 25 to the 2013 and 2014 Consolidated Financial Statements respectively.

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. The interest expense on the intra-group debt was not only disregarded in Chevron's financial statements, but also substantially greater than the net third party interest expense of 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. The table demonstrates that such ignorance tends to render the regime ineffective as an anti-avoidance measure.

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,[47] equivalent to approximately A$34 billion (at US$1 = A$1.2). This amount is ironically *less than* the intra-group debt of A$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 US13 billion is taken into account.[48] In that case, the net debt of the group would be US$15 billion, or A$18 billion, implying that the amount of the intra-group debt of CAH was almost double of the "real" net debt of the Chevron group.

Second, the 2014 Annual Report reveals that Chevron raised additional debt in the year "to take advantage of historically low interest rates".[49] The table below summarises the "real" interest rates borne by the Chevron group in 2014:

	Chevron group
Long-term notes	0.33% - 4.95%[50] (weighted average = 2%)
Commercial paper	0.12%[51]

[47] Chevron Corporation 2014 Annual Report, at 20.

[48] Chevron Corporation 2014 Annual Report, at 20.

[49] Chevron Corporation 2014 Annual Report, at 20.

[50] Chevron Corporation 2014 Annual Report, at 56. It should be noted that all notes born interest rates 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 A$35 billion intra-group debt with an interest rate of around 5%.

[51] Chevron Corporation 2014 Annual Report, at 57.

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.

2.4 Australia's thin capitalisation regime

Australia's thin capitalisation regime was first introduced in 1987 and experienced a major reform in 2001.[52] 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,[53] and (3) the worldwide gearing ratio test.[54]

The thin capitalisation regime is complex, occupying nearly 100 pages of legislation 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

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[52] The current regime is in Division 820, Income Tax Assessment Act 1997 ("ITAA1997"), 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, at 24-25. For a brief summary of thin capitalisation regimes in the world, including the historical evolution of the regime in Germany, see Martin Ruf & Dirk Schindler, "Debt Shifting and Thin-Capitalization Rules – German Experience and Alternative Approaches" (2015) *Nordic Tax Journal* 1:17-33, at 19-20, 22-24 & 26-27.

[53] 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). This contracts with the OECD's findings in its work on Action 4. In particular, the OECD ruled out the arm's length test early from the consultation process for a number of problems of the test, namely, 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, paragraph 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": Richard Vann and Chloe Burnett, Submission to BEPS Action 4 Discussion Draft, dated 6 February 2015 (available at https://www.oecd.org/tax/public-comments-action-4-interest-deductions-other-financial-payments.htm), at 235. For a discussion of UK's arm's length test and its problems, see Chloe Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach" (2014) *World Tax Journal*, February, 40, at 46-47. Ironically, the arm's length test appeared to have strong support from businesses as revealed in the consultation process: Amanda Athanasiou and David Stewart, "OECD Action 4 Draft Consultation Focuses on Fixed Ratios" *Worldwide Tax Daily*, 18 February 2015.

[54] 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 s.820-216 ITAA 1997.

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".[55] In broad terms, the current safe harbour debt limit is 60 per cent on a debt-to-asset basis.[56]

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.[57] 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.[58] 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 "Interest deduction exceeding net third party interest expense" below.

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[55] Board of Taxation, above fn. 52, paragraph 2.10.

[56] Section 820-195 ITAA 1997. The thin capitalisation regime applies different tests for different categories of entities. For the purposes of this paper, 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 did not announce any change to the test, possibly due to "big business lobbies": Thomson Reuters, *Weekly Tax Bulletin* no.18, at 542; and Nassim Khadem, "Aussies Unconvinced by Lawmakers' Tough Talk on MNEs" *Tax Notes International*, vol.82, 27 June 2016, 1273, at 1274. Another interesting point to note about Australian's thin capitalisation regime is that the regime was weakened in 2008 when the law was 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, paragraphs 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.

[57] The *Chevron* case, paragraph 99.

[58] Chevron Australia Holdings Pty Ltd, "Applicant's outline of submissions" (Federal Court of Australia File Number: NSD440/2013), paragraph 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), at 5.

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".[59]

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.[60] For instance, the Board of Taxation described the tension in this way (emphasis added):[61]

> 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".[62]

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

[59] 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/). The opposition party has proposed replacing the current thin capitalisation regime with a worldwide gearing ratio based on equity or asset. 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 to "introduce 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/consultations/tax-deductibility-of-corporate-interest-expense/tax-deductibility-of-corporate-interest-expense-consultation), paragraph 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": ibid, paragraph B.2.

[60] Other countries are likely to face with similar dilemma in the design of their interest limitation regimes. See for example the experience in Sweden: Peter Melz, "A proposal for business tax reform in Sweden" (2015) *British Tax Review*, No. 1, 6, at 6.

[61] Board of Taxation, above fn. 52, paragraphs 2.1 and 2.2.

[62] Richard Vann, "Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?" (2013) *British Tax Review*, no.1, 59, at 71. See also: Review of Business Taxation, *A Tax System Redesigned* (1999) (available at http://www.rbt.treasury.gov.au/publications/paper4/), 659-667.

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".[63]

Second, 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):[64]

> 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 vs 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 regime.[65] With respect to this issue, it has been argued elsewhere that in general, the

[63] Final Report, paragraph 109.

[64] Final Report, paragraph 108. For a discussion of the specific issues with respect to infrastructure projects, see: Discussion Draft, paragraph 215

[65] Discussion Draft, at 2. For a review of the current approaches adopted by countries to address the BEPS issues arising from interest expenses, see: Discussion Draft, Chapter III; Final Report, paragraphs 10-20; and also Brian Arnold, *International Tax Primer* (2016, Wolters Kluwer, Alphen aan den Rijn), at 1145-118; and Edoardo

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.[66] 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".[67]

However, the sole reliance on the financial position of an entity is ironically also the main problem of 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.[68]

The OECD recognised that one of the key concerns in Action 4 was that intra-group debts can be structured to obtain "relief for interest deductions *greater than the actual net interest expense of the group*" (emphasis added).[69] This concern was first raised in the Action Plan (emphasis added):[70]

Traversa, "Interest Deductibility and the BEPS Action Plan: nihil novi sub sole?" (2013) *British Tax Review*, 607, at 610-613.

[66] Antony Ting, "iTax – Apple's international Tax Structure and the Double Non-Taxation Issue" (2014) *British Tax Review*, No. 1, 40, at 60-65.

[67] Discussion Draft, paragraph 147; and Final Report, paragraph 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, paragraph 150. A detailed discussion of this issue is beyond the scope of this article.

[68] 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, paragraph 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, paragraph 149.

[69] Discussion Draft, paragraph 4.

[70] OECD, Action Plan on Base Erosion and Profit Shifting (available at https://www.oecd.org/ctp/BEPSActionPlan.pdf), at 16.

> From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity … The result is that the interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed favourably or not at all at the level of the recipient, and *sometimes the group as a whole may have little or no external debt*.

The Discussion Draft emphasised the important link between interest deductions by group companies and the actual third party interest cost as one of the key policy aims of Action 4 (emphasis added):[71]

> The critical objective of the work on Action is to identify coherent and consistent solutions to address [BEPS] using interest [expenses] … Countries engaged in the action agree that this aim is a key priority and may be best achieved through rules which encourage groups to adopt funding structures which more closely *align the interest expenses of individual entities with that of the overall group*. Overall, however, in general groups should still be able to *obtain tax relief for an amount equivalent to their actual third party interest cost*.

This issue was elaborated further by the OECD in its review of existing interest limitation regimes adopted by countries (emphasis added):[72]

> There is a general view that in many cases international groups are still able to claim total interest deductions *significantly in excess* of the group's actual third party interest expense.

This view is supported by empirical data as discussed in Section "Interest-to-earnings rule" below. It is therefore not surprising that the Final Report reiterated that interest deduction on intra-group debt in excess of a group's net third party interest expense was one of the three basic scenarios that gave rise to BEPS risks using interest expense.[73]

[71] Discussion Draft, paragraph 10. 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, paragraph 168; and Discussion Draft, paragraph 179.

[72] Discussion Draft, paragraph 27.

[73] Final Report, at 11. The other two basic scenarios were "placing higher levels of third party debt in high tax countries" and "using third party or intragroup financing to fund the generation of tax exempt income": ibid.

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,[74] 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.[75] 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).[76] 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".[77] In the design of an earnings-based fixed ratio rule, there are two key factors to decide: first, the definition of earnings; and second, 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 earning-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".[78] Second, EBITDA is a relatively widely tested definition, as it is the most common definition of earnings in existing earnings-based regimes.[79]

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

[74] Final Report, paragraphs 58 and 59.

[75] Final Report, paragraph 17.

[76] Final Report, paragraph 17.

[77] Final Report, paragraph 85.

[78] Discussion Draft, paragraph 157.

[79] Discussion Draft, paragraph 157. A small number of countries use 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, paragraph 155; and Final Report, paragraph 89.

rule for three reasons.[80] First, tax numbers are "reasonably straightforward to apply and audit".[81] Second, 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.[82] Third, and perhaps most importantly for anti-BEPS purposes, using tax EBITDA provides a strong link between interest deduction and taxable income, and thus rendering the rule more robust to combat BEPS.[83]

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.[84]

The most common benchmark ratio in existing earning-based fixed ratio rules is 30 per cent.[85] However, both empirical and anecdotal evidence indicates that this benchmark ratio may be too high to be effective for addressing BEPS risks.[86] In particular, the OECD observed that (emphasis added):[87]

> 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.

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[80] In contrast, the OECD recommended to use accounting numbers of an earning-based group ratio rule: Final Report, paragraph 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 difficulties for an entity to determine 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, paragraphs 121 and 122.

[81] Final Report, paragraph 88.

[82] Final Report, paragraph 88.

[83] Final Report, paragraph 88.

[84] Final Report, paragraph 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, at 330.

[85] Discussion Draft, paragraph 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 US 50%: ibid.

[86] Discussion Draft, paragraph 159.

[87] Discussion Draft, paragraph 27.

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:[88]

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

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 an overly 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.[89] 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).[90] 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.[91]

[88] The table is prepared based on the data provided in: Discussion Draft, paragraph 159.

[89] Final Report, paragraph 22.

[90] Discussion Draft, paragraph 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": ibid.

[91] The operation of the group-wide rule with respect to this issue was illustrated in Example 7 in the Discussion Draft: Discussion Draft, paragraphs 253-257.

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".[92] 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 partly due to the failure to secure enough support from participating countries for the group-wide rules, and partly the problems encountered in the design of these rules. The following paragraphs analyse the group-wide rules considered in the Discussion Draft.

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.[93] 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. The Discussion Draft emphasised that "… a group-wide test *directly* addresses issues of base erosion where a group claims relief for interest expenses *in excess of its actual interest costs* …" (emphasis added).[94]

A group-wide rule is an example of a relatively strong application of the enterprise doctrine. With respect to BEPS using intra-group debt, an application of the doctrine effectively looks through the intra-group arrangement, and allows tax authorities to determine the amount of interest deduction of an entity with reference to the net third party interest expense of the group. A group-wide rule is also superior to a fixed ratio rule in the sense that the former "has the

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[92] Final Report, at 11 and paragraph 18.

[93] 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, paragraph 61. Second, 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, paragraph 66.

[94] Discussion Draft, paragraph 60.

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".[95]

The Discussion Draft proposed two alternative group-wide rules, namely an interest allocation rule and a group ratio rule.[96] They are analysed in the following paragraphs.

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.[97] The Discussion Draft analysed two variations of the interest allocation rules: (1) a deemed interest rule; and (2) an interest cap rule.[98] 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.[99] 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.[100]

[95] Burnett, above fn. 3, at 327.

[96] Discussion Draft, paragraph 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, paragraphs 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, paragraph 101.

[97] Discussion Draft, paragraph 67.

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

[99] Discussion Draft, paragraph 75.

[100] 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. 97, at 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 amount unacceptable. Other commentators have also proposed similar deemed deduction rule, see for example: Chloe Burnett, "Interest Deductions and Multinational Enterprises: Goldilocks and the Brave New World" (2015) *Bulletin for International Taxation*, June/July, 326, at 328.

Second, 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.[101]

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.[102] 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".[103] 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".[104] There is little doubt that MNEs are most likely capable of managing this issue.[105]

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".[106]

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[101] Discussion Draft, paragraph 75. This issue was illustrated in Example 4 in Annex 3 of the Discussion Draft.

[102] Discussion Draft, paragraphs 76 and 183.

[103] Discussion Draft, paragraph 76.

[104] Discussion Draft, paragraph 183.

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

[106] Discussion Draft, paragraph 77.

No interest allocation rule was eventually included in the best practice approach in the Final Report as it suffered from a critical problem.[107] The rule would work properly *only if all countries apply the rule consistently*. As the Discussion Draft explained (emphasis added):[108]

> … when considering the design of a group-wide rule … a key factor is the degree of consistency between the rules applied in different countries. Therefore, for the purposes of this consultation document, it is anticipated that an interest allocation rule would be applied consistently, *with all countries applying the rule reaching agreement on the main elements (such as the definition of a group, the calculation of the group's net third party interest expense, and the allocation of interest expense between group entities).*

It is extremely difficult, if not impossible, to achieve international consensus on the adoption of a group-wide rule and the design of its main elements.[109] This is often the Achilles' heel for a strong multilateral application of the enterprise doctrine.[110]

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.[111] Any excess interest expense would be disallowed and may be carried forward to future years.[112]

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107 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, paragraph 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": ibid. Furthermore, additional information may be available with country-by-country reporting as recommended in Action 13 of the BEPS Project: Discussion Draft, paragraph 227. In contrast, some practitioners argued that the application of a group-wide rule would be "an extremely complex exercise": Oliver Hoor and Keith O'Donnell, "BEPS Action 4: When Theory Meets Practice" (2015) Tax Notes International, vol.78, 18 May 2015, 643, at 646.

108 Discussion Draft, paragraph 68.

109 David 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) Bulletin for International Taxation, June/July 2015, 350, at 350.

110 For a critical analysis of the original proposal of the EU-wide consolidation regime, see Antony Ting, "Multilateral formulary apportionment model – A reality check" (2010) *Australian Tax Forum* vol 25 no 1, 95.

111 Discussion Draft, paragraph 67.

112 Discussion Draft, paragraph 78.

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".[113]

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 the compliance costs of MNEs would increase,[114] but more importantly, the total interest deductions of group members may exceed the group's net third party interest expense.[115]

The OECD proposed two alternative combined approaches in the Discussion Draft.[116] 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.[117] The Final Report adopts largely the Approach 2, as explained in the next section.

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 they are effective for combating BEPS using interest deduction. Before proceeding, it is important to note that a best practice approach is optional for countries to adopt,[118] and represents a relatively weak consensus among

[113] Discussion Draft, paragraph 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, paragraph 87.

[114] Discussion Draft, paragraph 86.

[115] 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, paragraph 86.

[116] Discussion Draft, Chapter X.

[117] 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, paragraph 81; and Final Report, paragraph 118. For a discussion of the German group ratio rule, see for example: Burnett, above fn. 52, at 50-51.

[118] Countries are allowed to apply rules that are stricter than the best practice approach: Final Report, paragraph 31.

participating countries in comparison to for example a new minimum standard which has to be implemented by all countries.[119] 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.[120]

After the extensive analysis and consultation of alternative interest limitation rules, the OECD recommended a best practice approach as summarised below, which – in addition of the fact that the best practice approach itself is optional for countries to adopt – consists of many optional policies which do not always align with its own analysis:[121]

(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.[122] 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.[123] 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;[124]

(2) An earnings-based group ratio rule:[125] 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 interest expense up to its group's net

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[119] There are in general four categories of recommendations for the various BEPS Action items, namely and in the 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.

[120] OECD, *OECD/G20 Base Erosion and Profit Shifting Project – Explanatory Statement – 2015 Final Reports* (available at https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf), paragraphs 11 and 18.

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

[122] Final Report, Chapter 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 ration rule, an entity's EBITDA should be defined to be 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, paragraph 89.

[123] Final Report, paragraph 23.

[124] Discussion Draft, paragraphs 120-128.

[125] The OECD has continued its work on the detailed technical design of the group ratio rule. The Discussion Draft on this issue has been released by the OECD in July 2016 (available at https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-elements-of-the-design-of-group-ratio-rule.pdf).

interest-to-EBITDA ratio.[126] In addition to the option to 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. Second, 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) An optional de minimis monetary threshold for low risk entities: The OECD recommends that entities below the threshold should be excluded from the fixed ratio and group ratio rules, and the threshold should be based on net interest expense of all entities in a local group;[127]

(5) Targeted rules: The aim of these rules is to protect the general rules and to address specific BEPS risks;[128] and

(6) Specific rules for banking and insurance sectors.[129]

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 that put doubt on its effectiveness to combat BEPS using interest deduction.

4.1 Allowing Interest deduction exceeding net third party interest expense

The first problem of 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 objective –

[126] Final Report, Chapter 7.

[127] Final Report, paragraphs 54 and 55. The di minimis threshold is an important measure to minimise compliance and administration costs for interest limitation regimes. For example, the UK estimated that a threshold of £2 million would exclude 95% of groups from its proposed interest limitation regime: HM Treasury and HM Revenue & Customs, *Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation* (2016) (available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525923/tax_deductibility_second_consultation_v2.pdf), paragraph 3.5.

[128] Final Report, Chapter 9. For a discussion of these rules, see Section "Targeted rules" below.

[129] The Discussion Draft on the detailed technical design of the specific rules for banking and insurance industries has been released by the OECD in July 2016 (available at http://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf).

whose importance was repeatedly emphasised in the Discussion Draft – in its justification for the inclusion of a fixed ratio rule and a group ratio rule in the best practice approach.[130]

This problem can be illustrated by a 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[131]	**A$0.7B**	**A$1B**	**A$1.3B**	**A$1.8B**
EBITDA[132]	A$3.2B	A$4.6B	A$1.9B	A$1.7B
Interest limitation @ 30%	**A$1.0B**	**A$1.4B**	**A$0.5B**	**A$0.5B**
Chevron group:				
Interest expense per Income Statement[133]	US$0	US$0	US$0	US$0
Capitalised interest[134]	US$288M	US$242M	US$284M	US$358M
- equivalent A$ (@ 1.2 exchange rate)	A$0.3B	A$0.3B	A$0.3B	A$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. Second, 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 bothered by the thin capitalisation regime for all the relevant years, the fixed ratio rule would have disallowed substantial interest deductions in 2013 and 2014.[135]

[130] Final Report, paragraphs 23 to 25.

[131] Chevron Submission 121, at 8.

[132] 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.

[133] Chevron Annual Reports, at page 4 of the respective reports for 2011 to 2014.

[134] Chevron Annual Reports, Notes 24 and Note 25 to the 2013 and 2014 Consolidated Financial Statements respectively.

[135] 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.

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[136]	**A$0.7B**	**A$1B**	**A$1.3B**	**A$1.8B**
EBITDA[137]	A$3.2B	A$4.6B	A$1.9B	A$1.7B
Chevron group:				
Interest expense per Income Statement[138]	US$0	US$0	US$0	US$0
Capitalised interest[139]	US$288M	US$242M	US$284M	US$358M
EBITDA[140]	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)	**A$0**	**A$0**	**A$0**	**A$0**
Interest limitation (based on capitalised interest)	**A$0.03B**	**A$0.03B**	**A$0.02B**	**A$0.04B**

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".[141] The alternative definitions being considered include (1) interest expense figure taken from consolidated income statement without adjustment;[142] and (2) that figure but adjusting to include, among other things, capitalised interest.[143] The table above shows that if a group ratio rule adopts the interest expense figures in Chevron's consolidated income statements without adjustment, all

[136] Chevron Submission 121, at 8.

[137] 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.

[138] Chevron Annual Reports, at page 4 of the respective reports for 2011 to 2014.

[139] Chevron Annual Reports, Notes 24 and Note 25 to the 2013 and 2014 Consolidated Financial Statements respectively.

[140] Chevron Annual Reports for 2011 to 2014, Consolidated Statements of Income.

[141] OECD, *Public Discussion Draft – BEPS Action 4 – Elements of the Design and Operation of the Group Ratio Rule* ("Discussion Draft – Group Ratio Rule") (available at https://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-elements-of-the-design-of-group-ratio-rule.pdf).

[142] Discussion Draft – Group Ratio Rule, paragraph 6.

[143] Discussion Draft – Group Ratio Rule, paragraph 13.

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.

This case study shows that a group ratio rule – which, as discussed in Section "Group ratio rule" above, represents an indirect link between interest deduction and a group's real net third party interest expense – may be more effective to combat BEPS than a fixed ratio rule.

To be fair to the OECD, it had attempted to establish a link between its best practice approach and a MNE's net third party interest expense. However, a flawed assumption in the analysis dictated that this attempt was in vain. In the discussion of setting the "best practice corridor" for the benchmark ratio in the fixed ratio rule, the OECD stated that "the key aim is to identify a range of benchmark fixed ratios which … allows the majority of groups to deduct an amount equivalent to their net third party interest expense *(assuming net interest expense is spread around the group in accordance with accounting-EBITDA)* [and] *limits the extent to* which groups can use intragroup interest expense to claim total net interest deductions in excess of their net third party interest expense" (emphasis added).[144]

It is well-known that in the real world it is highly unlikely that a MNE allocates its net third party interest expense among its group members in accordance with accounting-EBITDA. It is unclear why the OECD adopted an assumption that was obviously wrong. Furthermore, the phrase "limit the extent" in the above citation suggests that the OECD was aware that the best practice approach would not prevent MNEs from claiming interest deduction in excess of their real interest expense.

The OECD has also failed to prevent a MNE from claiming interest deduction in excess of its net third party interest expense in its design of the group ratio rule. While it recognises that the group ratio rule allows a MNE to claim interest deduction up to its net third party interest expense,[145] 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

[144] Final Report, paragraph 95.

[145] Final Report, paragraph 150.

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".[146]

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 a general rule.[147] This emphasis on a low benchmark fixed ratio was reiterated in the Final Report in its discussion of the best practice approach (emphasis added):[148]

> … 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.[149] In fact, the OECD's own analysis demonstrated clearly that a 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.[150] 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*

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[146] Final Report, paragraph 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, paragraphs 151 and 152, and Examples 9b and 9c.

[147] Discussion Draft, paragraphs 168 and 170.

[148] Final Report, paragraph 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, paragraphs 25 and 115.

[149] This is especially so given the group ratio rule as recommended in the best practice would serve as a carve out for MNEs with higher gearing ratios.

[150] Final Report, paragraph 18. The experience with the 30% benchmark ratio in Germany also suggested that it was too generous: Lee Sheppard, "BEPS Interest Deduction Guidance Coming" *World Tax Daily*, 2 March 2015.

the issues to be addressed under Action 4" (emphasis added).[151] 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".[152] 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 to reform its interest limitation regime, consisting of a fixed ratio rule with a 30 per cent benchmark ratio.[153] The European Council has 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.[154]

The policy objective of competitiveness between countries is an important driver for adopting the 30 per cent benchmark ratio, as this is the most common ratio used in existing earning-based fixed ratio rules. For instance, the UK government justifies its proposal to adopt this benchmark ratio by stating that this is "consistent with the approach in several other countries and international best practice".[155] The desire to keep a country's tax system competitive against other countries may dictate that a country is likely to be reluctant to adopt a lower benchmark ratio.

It is still early days in the implementation phase of the OECD's recommendations for Action 4. However, the adoption of the 30 per cent benchmark ratio in the UK and the EU may suggest a convergence of national practice on this issue. If this is the case, for anti-BEPS purposes, it may be important to consider additional integrity rules – known as targeted rules in the Final Report – to enhance the effectiveness of an interest limitation regime to prevent deduction in

[151] Final Report, paragraph 253 in Example 5.

[152] Final Report, paragraph 109.

[153] HM Treasury and HM Revenue & Customs, *Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation* ("UK Consultation 2016") (available at https://www.gov.uk/government/consultations/tax-deductibility-of-corporate-interest-expense), May 2016, paragraph 5.1.

[154] Council of the European Union, *COUNCIL DIRECTIVE laying down rules against tax 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), July 2016, Article 4(1).

[155] UK Consultation 2016, paragraph 3.3.

excess of the net third party interest expense of a group. The following section explores some of the possible options for targeted rules.

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".[156] 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 do so.[157] In both the Discussion Draft and the Final Report, the OECD listed a number of targeted rules that countries may consider to adopt, 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.[158]

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 as the first example of targeted rules, suggesting that this type of rules might be regarded as relatively important as compared 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:[159]

> (i) disallow all interest payments to connected and related entities;[160] (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[161] …

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

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[156] Final Report, paragraph 168.

[157] Final Report, paragraph 168.

[158] Discussion Draft, paragraph 181.

[159] Discussion Draft, paragraph 181

[160] 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. 52, at 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": Lee Sheppard, "U.S. Goes After Earnings Stripping, Hits Cash Management" (2016) *Tax Notes International* vol.82, dated 18 April 2016, 215, at 216.

[161] For examples of this kind of targeted rules, see Traversa, above fn. 6, footnote 39.

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).[162] 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.[163] 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".[164]

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. Nevertheless, the following paragraphs review two targeted rules – the first one in Sweden and the next one in the UK – aiming to provide some insights into the design of this kind of anti-BEPS rules.

Targeted rule in Sweden[165]

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

[162] Final Report, paragraph 176. Other differences with respect to targeted rules between the Discussion Draft 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, paragraphs 171 and 173.

[163] Final Report, paragraphs 169 and 173.

[164] Final Report, paragraph 99.

[165] 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: Hussein Abdali and Tord Fredriksson, "Swedish interest deductibility: unilateral action proposed" (2015) *International Tax Review*, 11 May 2015; Sjoerd Douma, "Limitations on Interest Deduction: an EU Law Perspective" (2015) *British Tax Review*, 364, at

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 from adopting similar rules.[166]

In general, the Swedish regime applies an outright disallowance rule under which interest expense on intra-group debt is not deductible.[167] 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 has 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.[168] While Sweden has formally responded to the notice rejecting the allegation,[169] it has been reported that the country is considering amending or even replacing the regime with other interest limitation regimes.[170]

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

365; and Anna Hanko Farago, "Sweden – Reaction to the Final OECD BEPS Package" (2016) *International Transfer Pricing Journal*, vol.23, no.3, at section 2.2.

166 Abdali and Fredriksson, above fn. 162.

167 For a discussion of the definition of a group for the purpose of this regime, see: Behrang 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), at 9.

168 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. 162, at 365.

169 See for example: KPMG, "Tax News – Sweden's response to the European Commission on interest deductions" 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).

170 Abdali and Fredriksson, above fn. 162. The Swedish Committee on Corporate Taxation proposed reform options in 2014: Anna Hanko Farago, "Sweden – Reaction to the Final OECD BEPS Package" (2016) *International Transfer Pricing Journal*, vol.23, no.3, at section 2.2. For a discussion of the proposal, see: Melz, above fn. 59.

the regime, including (1) for the first exception, whether an intra-group debt was created with a main purpose to obtain tax benefit; and (2) for the second exception, whether the main purpose of an intra-group debt is for business reasons.[171]

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 targets a fundamental problem of the existing international tax regime, namely the respect of intra-group arrangement under the traditional separate entity doctrine. Instead, it represents an example of the application of the enterprise doctrine under which intra-group transactions in general are ignored for income tax purposes. Second, 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.

Debt cap rule in the UK

Another example of targeted rules is the debt cap rule in the UK. The main reason for analysing this rule here is that it represents an alternative measure to link an interest limitation regime to the "real" interest expense of a group. At the time of writing this article, the UK is undergoing consultation of the detailed policy design of its new interest limitation regime in response to the OECD's Final Report.[172] The following paragraphs analyse the proposed new debt cap rule, which will replace the existing debt cap rule.

In general, the proposed debt cap rule will limit interest deduction of a group in the UK to its worldwide group's net third party interest expense.[173] This cap will be applied on top of the fixed ratio and group ratio rules. In other words, the debt cap rule prevents a MNE from claiming in the UK interest deduction in excess of the group's "real" interest expense, even if the fixed ratio or group ratio rule allows it to do so.

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[171] 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. 162. 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.

[172] For details of the proposed new regime, see: UK Consultation 2016, above fn. 153.

[173] UK Consultation 2016, paragraphs 5.55 – 5.58.

The debt cap rule is not perfect in the sense that, while it limits interest deduction of a MNE in the UK to its net third party interest expense, it does not prevent the MNE from claiming more interest deductions in other countries. In other words, it is still possible for the MNE's total worldwide interest deductions to exceed its "real" interest expense. Nevertheless, given the emerging convergence of national practices adopting the best practice approach which implies that the group ratio rule is more likely to be adopted as a carve out instead of imposing a cap on interest deductions, the debt cap rule may be a pragmatic policy to reduce the BEPS risks arising from interest deductions exceeding a group's net third party interest expense.

The case study of Chevron suggests that a debt cap rule would be effective for anti-BEPS purposes. For instance, as shown in the tables in Section 4.1 above, the Chevron group reported zero interest expense (and minimal capitalised interest) in its consolidated financial statements from 2011 to 2014. A debt cap rule would have deny all – or almost all if capitalised interest is included in the cap – interest deductions of the group in Australia in those years. It suggests that this rule may be a simple targeted rule to combat BEPS especially by MNES with low or no gearing.[174]

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 the work on Action 4 with the aim to achieve 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. The case study on Chevron suggests that a net interest-to-EBITDA fixed ratio rule may be more

[174] This is a key policy objective of the proposed debt cap rule in the UK: UK Consultation 2016, paragraphs 3.8 and 4.10.

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.

Besides a group ratio rule, targeted rules similar to the Swedish regime or the proposed debt cap rule in the UK may provide much food for thought in the design of an interest limitation regime. In particular, the debt cap rule represents a relative simple measure that links to a group's "real" interest expense and may be effective to combat BEPS especially by low or no gearing MNEs. This is an area for future research, and is a story for another day.