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Tax Justice Network Australia Submission to the Inquiry on Tax Deductibility

15 January 2016

The Tax Justice Network Australia (TJN-Aus) welcomes the opportunity to make a submission to this inquiry into tax deductibility. The submission will only focus on the term of reference:

> The company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income.

The TJN-Aus believes the ability of businesses to claim tax deductions for interest repayments, especially in relation to interest repayments made to another part of the same corporation located overseas, should be curtailed. However, given revenue shortages to fund services for mental health, disability support, domestic violence services, alcohol and drug services, indexing welfare payments, Medicare and diagnostic tests, legal aid, financial counselling, public transport infrastructure, the Fair Work Ombudsman, the Australian Federal Police in combating online child sexual abuse, schools, the Australian Taxation Office, overseas development assistance and universities, research and VET to name just a few areas of inadequate government funding, any revenue gained for reforms addressing interest deductibility for businesses should be used for funding these needs and not for providing further company tax cuts.

Recommendations

The Committee should make the following recommendations to the Federal Government:

1. Interest deductions should be assessed on the debt-to-equity ratio of a company's entire global operations, eliminating the current debt-to-equity safe harbour of 60% and the arm's length debt test.
2. Support moves internationally to apply a formulaic apportionment of debt across a multinational enterprise based on the substance of its operations rather than on artificial legal structures.
3. Introduce legislation disallowing deductions for transactions with resident entities of a jurisdiction that does not effectively exchange information with the ATO (which is already used by Argentina, Brazil, Germany, India and Italy).
4. Introduce legislation to allow the Commissioner for Taxation the ability to deny a deduction where a foreign jurisdiction does not treat the income from the deduction as taxable income at their end or allows the income to be treated as a deduction in that jurisdiction (a double deduction).
5. Modify tax legislation to ensure that deductions are denied for a payment where the payee sets the income from that payment off against expenditure under a separate hybrid mismatch arrangement.

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1. Artificial Debt Loading as a Problem

The OECD stated that:[1]

> *The influence of tax rules on the location of debt within multinational groups has been established in a number of academic studies and it is well known that groups can easily multiply the level of debt at the level of individual group entities via intra-group financing. Financial instruments can also be used to make payments which are economically equivalent to interest but have a different legal form, therefore escaping restrictions on the deductibility of interest. Base Erosion and Profit Shifting (BEPS) risks in this area may arise in three basic scenarios:*
>
> - *Groups placing higher levels of third party debt in high tax countries.*
> - *Groups using intragroup loans to generate interest deductions in excess of gthe group's actual third party interest expense.*
> - *Groups using third party or intragroup financing to fund the generation of tax exempt income.*

The deductibility of interest payments on debt creates a tax-induced bias towards debt financing over equity financing, especially in a cross-border context.[2] The distortion is compounded by tax planning techniques that may be employed to reduce or eliminate tax payments in a jurisdiction with corporate income tax rates in the normal range.[3]

In the cross-border context, the main tax policy concerns surrounding interest deductions relate to the debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution. On the other hand, subsidiary entities may be heavily debt financed, using excessive deductions on intragroup loans to avoid paying taxes on local profits. Taken together, these opportunities surrounding inbound and outbound investment potentially create distortions and unfair advantages for groups operating internationally and those operating in the domestic market. This has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by multinational groups rather than domestic groups.[4]

Artificial debt-loading by multinational corporations operating in Australia, both foreign and Australian, has been identified as an area open to tax avoidance. In 2014, the Commissioner of Taxation stated multiple times that the ATO was investigating debt dumping into Australia, sometimes involving inflated asset valuations to provide a façade of compliance with thin capitalisation safe harbours.[5]

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[1] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 11.

[2] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 15.

[3] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 15.

[4] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 15.

[5] Chris Jordan, 'Commissioner's address to ICAA', Melbourne, ATO Media Centre 12 June 2014, https://www.ato.gov.au/Media-centre/Speeches/Commissioner/Commissioner-s-speech-to-ICAA-Practice-Forum-2014/; Chris Jordan, 'Reinventing the ATO – building trust in Australia's tax

Treasury noted in May 2013 there was a need for reform to address artificial debt loading by multinational enterprises:[6]

> *The Commissioner of Taxation has observed some aggressive tax structures that seek to take advantage of the generosity of the current rules and allows profits to be shifted through excessive debt allocations. The structure involves exploiting a combination of the current thin capitalization settings, an inconsistency in the law to not impede Australian firms investing overseas and a measure that was intended only to reduce compliance costs. It is now clear that these provisions are being abused as part of a profit shifting strategy that results in no significant change to economic activity in Australia.*

In the presentation to the Victorian Tax Institute the ATO revealed that International Dealing Schedules (IDS) submitted by businesses showed that around $10 billion was paid on debts of $234 billion in 2012, at an average interest rate of 4.39%. In the same year, around $5 billion of interest payments were made to Australian entities from overseas on loans of $160 billion, with an average interest rate of 3.24%.[7] The ATO asked "Why would Australian entities make loans to foreign related parties at 3.25% when they can get more than that with secure investments in Australia?"[8] The obvious answer is for the purposes of tax avoidance, although the ATO acknowledged that different currencies and terms could explain part of the difference. The ATO pointed out these loans "could be viewed as revenue leakage of $1.8b".[9] The ATO also asked the rhetoric question "Australia has maintained relatively high interest rates compared to other developed countries, so why lend overseas for less? – as is suggested by the IDS values."[10]

The ATO reported in September 2013 of the 2,168 entities identified as reporting more than $100 million in total annual income had $271 billion in related party borrowings (interest free and interest bearing) between them which accounted for 26% of their total debt in 2012.[11] The banking and financial services sector and energy and resources entities accounted for over 70% of the total related party borrowings.[12] The related party borrowings to total debt ratio for the three industry sectors have been relatively stable throughout 2006 to 2012.[13] The banking and financial services sector had the largest value of international related party borrowings (interest bearing and interest free) which are concentrated across fewer entities (five to six entities), and related party borrowings to total debt is 9% for the sector.[14] This

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administration', Sydney, ATO Media Centre, 14 April 2014, https://www.ato.gov.au/Media-centre/Speeches/Commissioner/Reinventing-the-ATO---building-trust-in-Australia-s-tax-administration/; Andrew Mills, 'I've looked at tax from both sides now', ATO Media Centre, Melbourne, 10 October 2014, https://www.ato.gov.au/Media-centre/Speeches/Other/I-ve-looked-at-tax-from-both-sides-now/; Mark Konza, 'Base erosion and profit shifting – a progress report on G20/OECD action', Melbourne, ATO Media Centre, 25 September 2014, https://www.ato.gov.au/Media-centre/Speeches/Other/BEPS---a-progress-report-on-G20/OECD-action/; and Mark Konza, 'Base erosion and profit shifting', Sydney, ATO Media Centre, 26 November 2013, https://www.ato.gov.au/Media-centre/Speeches/Other/Base-erosion-and-profit-shifting/?page=1#Footnotes

[6] The Australian Government Treasury, 'Addressing profit shifting through the artificial loading of debt in Australia', 14 May 2013, p. 1.
[7] Australian Taxation Office, Presentation to the Tax Institute, 2014.
[8] Australian Taxation Office, Presentation to the Tax Institute, 2014.
[9] Australian Taxation Office, Presentation to the Tax Institute, 2014.
[10] Australian Taxation Office, Presentation to the Tax Institute, 2014.
[11] Australian Taxation Office, 'Corporate Transparency Overview', September 2013, p. 1.
[12] Australian Taxation Office, 'Corporate Transparency Overview', September 2013, p. 10.
[13] Australian Taxation Office, 'Corporate Transparency Overview', September 2013, p. 10.
[14] Australian Taxation Office, 'Corporate Transparency Overview', September 2013, p. 10.

ratio is 30% for energy and resources corporations reflecting a higher dependence on related party funding for Australian resource investments.[15]

Of the 2,168 business entities with more than $100 million in total annual income, 700 entities lodged a thin capitalisation schedule or International Dealings Schedule for the 2012 financial year.[16] Of the general investor entities, 15% (91) had a financing structure that was above the 60% proposed safe harbour announced by the previous Government.[17] Of the financial and authorised deposit taking institutions, 22% (11) had a financing structure that was near or exceeding the current safe harbour limit of 95% debt to assets ratio.[18] The ATO pointed out that “Revaluations and internally generated goodwill are included in asset values for thin capitalisation purposes which can reduce gearing to below safe harbour”.[19]

The OECD has noted that the tax treatment of debt means that “leveraging high-tax group companies with intra-group debt is a very simple and straightforward way to achieve tax savings at group level.”[20] It concludes the tax treatment of related party debt-financing is a key pressure area[21] and that thin capitalization rules are a relevant domestic anti-avoidance strategy.[22] The Mirrlees review of taxation also identified that financial innovation increased the ability of corporations to exploit differences in the tax treatment of debt and equity.[23]

Work by Taylor and Richardson found that for publicly listed Australian companies thin capitalisation and transfer mispricing were the primary methods of tax avoidance in the period 2006 to 2009.[24]

Taylor and Richardson (2013) investigated the determinants of thinly capitalised structures of publicly-listed Australian firms. They used regression analysis of a sample of 203 publicly-listed Australian companies over the period 2006-2009.[25] Based on the magnitude and significance levels of the regression coefficients in their study, variables pertaining to multinationality and tax haven utilisation were, in particular, significantly and positively associated with firms' thin capitalisation position. They also presented supplementary evidence which showed that corporate governance monitoring mechanisms relating to board of director independence, institutional ownership and ‘Big-4’ auditor employment were significantly negatively associated with firms' thinly capitalised position.[26]

[15] Australian Taxation Office, ‘Corporate Transparency Overview’, September 2013, p. 10.
[16] Australian Taxation Office, ‘Corporate Transparency Overview’, September 2013, p. 11.
[17] Australian Taxation Office, ‘Corporate Transparency Overview’, September 2013, p. 11.
[18] Australian Taxation Office, ‘Corporate Transparency Overview’, September 2013, p. 11.
[19] Australian Taxation Office, ‘Corporate Transparency Overview’, September 2013, p. 11.
[20] OECD, ‘Addressing Base Erosion and Profit Shifting’, OECD Publishing, http://dx.doi.org/10.1787/9789264192744-en, 2013, p. 43.
[21] OECD, ‘Addressing Base Erosion and Profit Shifting’, OECD Publishing, http://dx.doi.org/10.1787/9789264192744-en, 2013, p. 6.
[22] OECD, ‘Addressing Base Erosion and Profit Shifting’, OECD Publishing, http://dx.doi.org/10.1787/9789264192744-en, 2013, p. 38.
[23] Alan Auerbach, ‘The Mirrlees Review: A US Perspective’, *National Tax Journal*, June 2012, p. 15.
[24] Grantley Taylor and Grant Richardson, “International Corporate tax Avoidance Practices: Evidence from Australian Firms”, The International Journal of Accounting **47**, (2012), p. 491.
[25] Grantley Taylor and Grant Richardson, ‘The determinants of thinly capitalised tax avoidance structures: evidence from Australian firms’, *Journal of International Accounting, Auditing and Taxation*, **22** (2013), p. 12.
[26] Grantley Taylor and Grant Richardson, ‘The determinants of thinly capitalised tax avoidance structures: evidence from Australian firms’, *Journal of International Accounting, Auditing and Taxation*, **22** (2013), p. 23.

In combination, the three Ralph Review changes to Australia's international arrangements gifted tax planners and their clients a decade of unprecedented opportunity to misuse the new regime.

As noted by the Business Tax Working Group Discussion Paper, Australia's thin capitalization rules allow for significant profit shifting opportunities, noting:[27]

> *The large information asymmetry that third parties face when auditing (or potentially auditing) tax calculations that can be based on subjective market and firm-specific information and assumptions raises integrity concerns.*

The Business Tax Working Group discussion paper noted Australia's thin capitalization rules have given "multinationals a tax advantage over their Australian market competitors"[28], as:

> *It should also be kept in mind that the gearing levels these rules allow are higher than the levels employed by those firms that have little capacity/incentive to shift profits out of Australia (that is, purely domestic firms or firms that rely on truly independent financing arrangements).*

The leak of letters from PricewaterhouseCoopers to Luxembourg tax authorities for advance rulings[29] on tax arrangements for 343 corporate clients has been of significant concern to governments and tax authorities who may have been impacted by these arrangements. Australian companies and multinational enterprises (MNEs) operating in Australia were amongst those who made use of PricewaterhouseCoopers services in setting up arrangements in Luxembourg.

It is alleged that hundreds of billions of dollars were channelled through Luxembourg by the advance rulings provided by the Luxembourg tax authority, resulting in the MNEs involved paying billions of dollars less in tax compared to if the arrangements were not in place.[30] Some MNEs enjoyed effective tax rates of less than 1% on the profits they shifted into Luxembourg.[31] It is further alleged that in many cases Luxembourg subsidiaries handling hundreds of millions of dollars in business maintain little presence and conduct little economic activity in Luxembourg.[32] One popular address – 5, rue Guillaume Kroll – is alleged to be home to more than 1,600 companies.[33]

The alleged tax dodging activities by MNEs through Luxembourg have included hybrid loans that are treated as debt but act like equity, which were used to realise profits as equity returns which avoid income and withholding taxes.[34]

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[27] Business Tax Working Group, Discussion Paper, 13 August 2012, p. 25.
[28] Business Tax Working Group, Discussion Paper, 13 August 2012, p. 25.
[29] UK Public Accounts Committee, 'Oral evidence: Tax avoidance: the role of large accountancy firms - follow-up, HC 860', 8 December 2014 , p. 7, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/tax-avoidance-the-role-of-large-accountancy-firms-followup/oral/16207.pdf
[30] Michael Hudson, Sasha Chavkin and Bart Mos, 'Big 4 Audit Firms Play Big Role in Offshore Murk', International Consortium of Investigative Journalists, icij.org, 5 November 2014, http://www.icij.org/project/luxembourg-leaks/big-4-audit-firms-play-big-role-offshore-murk
[31] Michael Hudson, Sasha Chavkin and Bart Mos, 'Big 4 Audit Firms Play Big Role in Offshore Murk', International Consortium of Investigative Journalists, icij.org, 5 November 2014, http://www.icij.org/project/luxembourg-leaks/big-4-audit-firms-play-big-role-offshore-murk
[32] Michael Hudson, Sasha Chavkin and Bart Mos, 'Big 4 Audit Firms Play Big Role in Offshore Murk', International Consortium of Investigative Journalists, icij.org, 5 November 2014, http://www.icij.org/project/luxembourg-leaks/big-4-audit-firms-play-big-role-offshore-murk
[33] Michael Hudson, Sasha Chavkin and Bart Mos, 'Big 4 Audit Firms Play Big Role in Offshore Murk', International Consortium of Investigative Journalists, icij.org, 5 November 2014, http://www.icij.org/project/luxembourg-leaks/big-4-audit-firms-play-big-role-offshore-murk
[34] 'Lux leaks', *The Australian Financial Review,* 6 November 2014, p. 10.

The recent changes to the thin capitalization rules through the *Tax and Superannuation Laws Amendment (2014 Measures No 4) Act 2014* were expected to impact on 185 inward investing general entities with estimated total debt deductions of $3.7 billion and 145 outward investing general entities with estimated total debt deductions of $5.0 billion.[35]

The previous gearing ratio allowed in the safe harbor debt limits was much higher than the normal gearing levels of most corporates with truly independent arrangements. As noted on page 4 of the Exposure Draft of the Explanatory Memorandum “recent data suggests these limits are now higher than the normal gearing levels of most corporates with truly independent financing arrangements, which is often less than 1:1 on a debt-to-equity basis.”

However, the TJN-Aus remains concerned the current debt-to-equity approach in Australian law is open to abuse by entities finding ways of having their Australian assets overvalued in order to load them up with debt and maximize the deductions allowed under the safe harbor limit. The reduction in the safe harbor limits in the *Tax and Superannuation Laws Amendment (2014 Measures No 4) Act 2014* is likely to provide further incentive to this form of abuse. The TJN-Aus recommends a thorough study to examine how widespread the overvaluing of assets is.

The TJN-Aus is concerned about the increase in the *de minimis* threshold for the application of the thin capitalisation limits from $250,000 to $2 million of debt deductions in the *Tax and Superannuation Laws Amendment (2014 Measures No 4) Act 2014*. This would appear to be large for small businesses and the TJN-Aus is concerned to the degree this may open up additional opportunities for abuse of debt loading and interest deductions. The TJN-Aus notes the ATO estimated the increase in the *de minimis* threshold resulted in almost half of the entities currently subjected to the thin capitalization rules being exempted (an exemption for 1,200 entities out of 2,500 previously subject to the rules).[36]

[35] The Board of Taxation, ‘Review of the Thin Capitalisation Arm’s Length Debt Test’, Discussion Paper, December 2013, p. 19.
[36] The Board of Taxation, ‘Review of the Thin Capitalisation Arm’s Length Debt Test’, Discussion Paper, December 2013, p. 19.

2. Chevron Case Study

Chevron, the US-based global oil giant, is now the largest foreign investor in Australia.[37] The Chevron operated Gorgon liquefied natural gas (LNG) project in Western Australia is the largest resource project in Australia and the largest LNG project in the world.[38] When the Gorgon gas begins to flow, LNG will overtake iron ore as Australia's largest export.[39]

In Australia, the majority of Chevron's Australian operations are owned through one company, Chevron Australia Holdings Pty Ltd.[40] The Australian company is owned by Chevron Australia Petroleum Company[41], a shell company incorporated in Delaware. While the Delaware parent company holds over $9.1 billion worth of shares in Chevron Australia and has shifted $35 billion to Australia.[42]

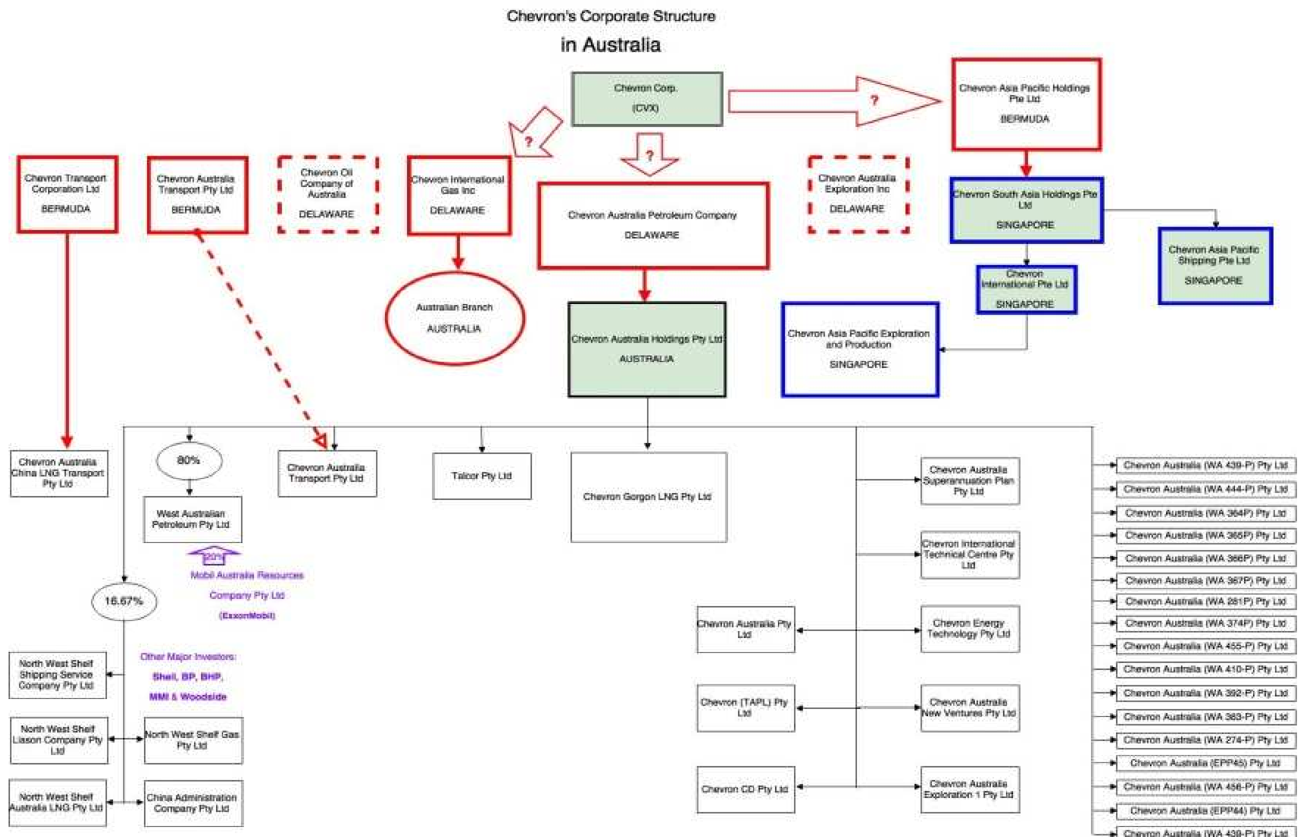

Figure 1: Chevron's Corporate Structure in Australia[43]

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[37] Chevron Australia Pty Ltd, Submission to the Parliamentary Inquiry on Corporate Tax Avoidance, 30 July 2015, p.2. http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions (Submission #121)

[38] https://www.chevronaustralia.com/our-businesses/gorgon

[39] James Paton, "LNG Seen Overtaking Iron Ore as Australia's Main Export Driver", Bloomberg, 23 July 2015. http://www.bloomberg.com/news/articles/2015-07-23/lng-seen-overtaking-iron-ore-as-australia-s-main-export-driver

[40] Chevron Australia Holdings Pty Ltd, Annual report, For the Year Ended 31 December 2014. (obtained through ASIC); Also see Chevron Australia Pty Ltd, Submission to the Parliamentary Inquiry on Corporate Tax Avoidance, 30 July 2015.

[41] Chevron Australia Holdings Pty Ltd, Annual report, For the Year Ended 31 December 2014. (obtained through ASIC).

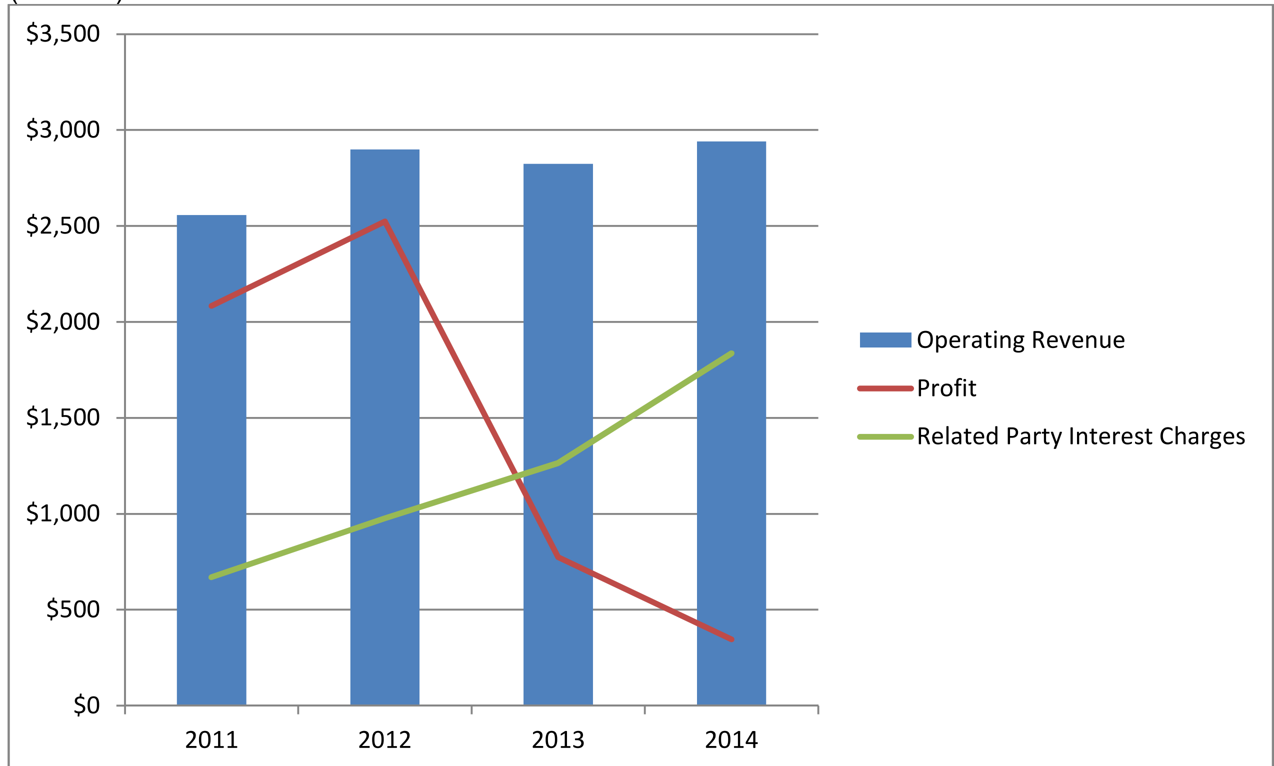
[42] Chevron Australia Holdings Pty Ltd, Annual report, For the Year Ended 31 December 2014. (obtained through ASIC).

[43] Structure derived from Chevron Australia Pty Ltd 2014 Annual Report, Chevron Australia Submission to the Parliamentary Inquiry on Corporate Tax Avoidance, Australian Securities and

Since 2011, Chevron Australia has reported annual operating revenues of over $2.5 billion.[44] While some corporate tax was paid in Australia, Chevron received refunds from the ATO of over $25 million in 2011 and nearly $6 million in 2014.[45] The release of ATO data in December 2015 reported that Chevron Australia Holdings Pty Ltd had total income of $3.03 billion in the 2013-2014 financial year and it had no taxable income and paid no tax.

Chevron's operating revenues in Australia had increased 15% between 2011 and 2014.[46] Meanwhile, our calculations appear to show interest charges to the parent company in Delaware have increased from 26% to 62% of operating revenue. Over the same period, profits appear to have plunged by 83%.

Figure 2. Revenue, Profit and Delaware Interest Payments: Chevron Australia 2011-2014.
(Millions)



In 2014, Chevron's interest deductions to the Delaware parent appear to have been more than five times greater than profits in Australia.

The ATO won a recent court case against Chevron in the Federal Court over Chevron loading up its Australian subsidiary with debt. Between 2004 and 2008, Chevron loaned itself $2.45 billion from Delaware. The money was borrowed in Delaware at 1.2% and lent to its

Investments Commission searches, Delaware Division of Corporation searches and Chevron Singapore subsidiary company annual reports.

[44] Chevron Australia Holdings Pty Ltd, Annual reports, For the Years Ended 31 December 2014 and 2012. (obtained through ASIC).

[45] Chevron Australia Holdings Pty Ltd, Annual reports, For the Years Ended 31 December 2014 and 2012. (obtained through ASIC).

[46] Chevron Australia Holdings Pty Ltd, Annual reports, For the Years Ended 31 December 2014 and 2012.

Australian subsidiary at interest rates above 8%.[47] The Chevron Finance Corporation loaned the money to Chevron Australia Holdings Pty Ltd as an unsecured loan in Australian dollars, which allowed Chevron Finance Corporation to increase the interest rate to the Australian bank bill rate plus a 4.14% margin.[48] So the interest rate paid from the Australian company to its US subsidiary was 8.2% in 2004 and by 2008 was 11.2%.[49] The interest deductions paid from Chevron Australia to Chevron Finance Corporation were not taxable in the US, because Chevron Finance Corporation was a subsidiary of Chevron Australia.[50] From 2004 to 2008 Chevron Finance Corporation earned profits of $1.1 billion from the loan, which it paid as dividends back to Chevron Australia, which it didn't pay tax on either, under the US-Australia tax treaty.[51] The ATO stated Chevron had used the loans and related-party payments to cut its taxes paid in Australia by $258 million.[52]

The ATO set out two positions. It argued that 80% of Chevron Australia's business was in US dollars and that putting the loan in Australian dollars was merely a pretext for charging higher Australian interest rates. The ATO argued the implicit support from Chevron Corporation meant the true arm's length interest rate was the London Interbank Offer Rate for US dollars plus a margin of 0.73%. Alternatively, it argued the US dollar Libor margin should be 1.75%.[53]

While that was the position the ATO took in the court, when it came to claiming back the tax avoided by Chevron, the ATO took a much more conservative line. It issued assessments on the basis that the arm's length interest rate was Australian dollar Libor, plus 0.1% or 0.2%.[54]

So approximately, Chevron Finance Corporation was paying 2% interest and charging 9% on average, while the ATO was willing to let them get away with an arm's-length rate of 5%.[55] In the view of the TJN-Aus this is an example of the problems with the arm's length rule. In this particular case it appears an artificial interest rate becomes acceptable to the ATO because of the arm's length rule rather than the actual arrangement that was entered into and the real costs to Chevron. It would appear that had Chevron only charged itself a 5% interest rate, then, in our opinion, it would have been free to tax avoid over a hundred million dollars through interest deductions to its US subsidiary.

The court found that the interest paid by Chevron Australia Holdings Pty Ltd to its US subsidiary Chevron Texaco Corporation over the five-year period exceeded an "arm's length

[47] Georgia Wilkins, "ATO alleges complex Chevron scheme slashed tax bill by $258m", *The Sydney Morning Herald,* 9 Oct. 2014. http://www.smh.com.au/business/ato-alleges-complex-chevron-scheme-slashed-tax-bill-by-258m-20141008-113696.html; Nassim Khadem and Sarah Danckert, "Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill", The Sydney Morning Herald, 23 October 2015; and Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[48] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[49] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[50] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[51] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[52] Nassim Khadem and Sarah Danckert, "Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill", *The Sydney Morning Herald,* 23 October 2015.

[53] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[54] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[55] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

price" for borrowing, as related to transfer pricing rules.[56] Justice Alan Robertson agreed with the ATO that the loan arrangement's "dominant purpose" was to "obtain a scheme benefit."[57] Chevron has stated that it may appeal the decision.[58]

The court case only covered the period of 2004 to 2008 and Chevron Finance Corporation went on to make another $1.57 billion tax-free profit before it was wound up in December 2010.[59]

However, the recent court case is not an end to the concerns about debt loading by Chevron and other oil and gas corporations into Australia. The *Australian Financial Review* reported that "Chevron, ExxonMobil and Shell are facing a showdown with the Tax Office over tax-free profits of up to $3 billion a year they are making from the huge Gorgon project, even before they have shipped the first gas."[60] It was alleged the tax-free profits were the result of interest rate arbitrage.[61]

In 2009, Chevron began a new $36.5 billion 'credit facility' between Australia and Delaware.[62] The interest rate was set again in Australian dollars, at the Australian bank bill rate plus a 2.63% margin.[63] This shift of funds, 14 times larger than the previous scheme, is to be repaid from 2016 through 2021.[64] This matches the expected start of LNG flows from the Gorgon project.

Globally, Chevron had debt of only $34 billion and, according to the *Australian Financial Review,* "since 2012, Chevron Australia has carried more debt than the entire group."[65]

The interest rate appears to be at least 5%.[66] In stark contrast, Chevron's subsidiaries in Singapore lend to each other at interest rates below 0.2%.[67]

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[56] Nassim Khadem and Sarah Danckert, "Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill", *The Sydney Morning Herald,* 23 October 2015; and Ben Hagermann, "Chevron tax dodge busted for $322 million", *Australian Mining,* 26 October 2015.
[57] Nassim Khadem and Sarah Danckert, "Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill", *The Sydney Morning Herald,* 23 October 2015.
[58] Nassim Khadem and Sarah Danckert, "Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill", *The Sydney Morning Herald,* 23 October 2015; and Ben Hagermann, "Chevron tax dodge busted for $322 million", *Australian Mining,* 26 October 2015.
[59] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.
[60] Neil Chenoweth, "Chevron, ExxonMobil & Shell and the $3 billion Gorgon tax two-step", *Australian Financial Review*, 16 August 2015. http://www.afr.com/news/policy/tax/chevron-exxonmobil--shell-and-the-3-billion-gorgon-tax-twostep-20150814-gizijk
[61] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.
[62] Chevron Australia Holdings Pty Ltd, Annual reports, For the Years Ended 31 December 2012 and 2014; and Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.
[63] Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.
[64] Chevron Australia Holdings Pty Ltd, Annual report, For the Year Ended 31 December 2014.
[65] Neil Chenoweth, "Chevron, ExxonMobil & Shell and the $3 billion Gorgon tax two-step", *Australian Financial Review*, 16 August 2015.
[66] Neil Chenoweth, "Chevron, ExxonMobil & Shell and the $3 billion Gorgon tax two-step", *Australian Financial Review*, 16 August 2015. The interest rate given is BBSW + 2.63%. BBSW stands for the Bank Bill Swap Rate. The current mid rate (11-8-2015) for a ten year loan is 3.19%. http://www.afma.com.au/data/BBSW. If this is the rate being used, the total interest rate would be 5.82%.
[67] 2013 Annual reports for multiple Chevron subsidiaries in Singapore show interest rates for related party loans of between 0.17% and 0.19%, These subsidiaries include: Chevron International Pte Ltd

In 2014 alone, this new scheme resulted in a $1.8 billion interest deduction to the Delaware parent.[68] This amount was not paid, but 'capitalised'[69], and may amass more interest deductions to be used later to further reduce taxes paid in Australia. The *Australian Financial Review* noted that if the actual rate was 0.3%, the interest deduction "would have been $110 million, leaving an offshore profit of $1.73 billion."[70] It is further reported the actual costs on the loans to the US arm of Chevron are only $350 million, so that Chevron Australia Petroleum Company (based in Delaware) made a $1.5 billion profit from the arbitrage in 2014.[71] According to the one page annual report filed in 2014, the Delaware parent company has a tax bill of US$175 for that year.[72]

Chevron Australia has a debt-to-equity ratio of 76.2% almost 10 times the 8.5% ratio of Chevron Corporation.[73]

Chevron's interest rates to its Australian subsidiaries to itself from other parts of Chevron located overseas could divert profits from Australia to Delaware and offset future tax revenue by more than $35 billion.[74]

Chevron Australia, in its recent submission to the Senate Inquiry on Corporate Tax Avoidance, has revealed that the ATO is auditing this arrangement.[75]

Of concern, the US Government has not approved Chevron's tax filings for over seven years.[76]

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and Chevron Asia Pacific Shipping Pte Ltd which both appear to have relationships with Chevron subsidiaries in Australia.

[68] Chevron Australia Holdings Pty Ltd, Annual report, For the Year Ended 31 December 2014.

[69] Chevron Australia Holdings Pty Ltd, Annual report, For the Year Ended 31 December 2014.

[70] Neil Chenoweth, "Chevron, ExxonMobil & Shell and the $3 billion Gorgon tax two-step", *Australian Financial Review,* 16 August 2015.

[71] Ben Hagermann, "Chevron tax dodge busted for $322 million", *Australian Mining,* 26 October 2015; and Neil Chenoweth, "ATO eyes Chevron's $1.7b Gorgon profit", *Australian Financial Review,* 10 November 2015.

[72] International Transport Workers' Federation submission to Senate Economics Committee inquiry into Corporate Tax Avoidance, 9 November 2015, p. 7.

[73] International Transport Workers' Federation submission to Senate Economics Committee inquiry into Corporate Tax Avoidance, 9 November 2015, p. 8.

[74] Calculations of compounded interest payments at 5+% interest rates over the loan period could result in interest payments over $40 billion.

[75] Chevron Australia Pty Ltd, Submission to the Parliamentary Inquiry on Corporate Tax Avoidance, 30 July 2015, p.2.
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions (Submission #121)

[76] Nassim Khadem and Sarah Danckert, "Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill", *The Sydney Morning Herald,* 23 October 2015.

3. Solutions to the Problem of Artificial Debt Loading

The current approach to thin capitalization is in effect to allow companies to artificially debt load up to the debt-to-equity safe harbour. It effectively sets a safe limit on the acceptable amount of tax avoidance a multinational enterprise can enter into without facing challenge. In theory the ATO could use the general anti-avoidance rule, Part VIA, to mount a tax avoidance case against a business that has artificially loaded itself up with debt up to the safe harbor threshold for the primary purpose of avoiding paying corporate income tax in Australia, but to the Unit's knowledge no such case has ever been attempted. Transfer pricing rules might also be used to limit the size of the deduction. However, the reality is if a multinational enterprise does not get excessively greedy, it is able to tax avoid through the use of interest payments on debt it loads on itself from another part of itself located overseas, up to the safe harbor limit.

The OECD did not include recommendation of a debt-to-equity ratio approach with a fixed safe harbour limit in its BEPS Action 4 report as it was not seen as best practice and allows MNEs to manipulate the outcome of the test by increasing the level of equity in a particular subsidiary.[77]

As an immediate measure, interest deductions should be assessed on the debt-to-equity ratio of a company's entire global operations, eliminating the current debt-to-equity safe harbour of 60% and the arm's length debt test. The OECD plans to complete work on a worldwide group ratio rule in 2016.[78] However, while TJN-Aus sees such a change as a significant improvement over a fixed level debt-to-equity ratio of 60%, it is still open to manipulation if an MNE is able to artificially inflate the amount of equity in Australia compared to the amount of equity that would actually be in Australia if not for seeking to avoid tax through interest repayments. That said, it should still place a significant curb on the level of tax dodging using artificial debt loading of Australian subsidiaries by MNEs.

The OECD has pointed out that the limited empirical studies available have found that interest deduction limitation rules resulted in no significant reduction in investment, either as a result of thin capitalisation rules or interest barrier rules based on a ratio of interest expense to income.[79] They concluded "there does not seem to be enough empirical evidence to reach conclusions on the actual impact or interest limitation rules on foreign investment."[80]

The OECD has pointed out that simply limiting restrictions on debt loading to intragroup debt creates a response where intragroup debt decreases, but there is an increase in third party debt, although this may not be to the same extent (which TJN-Aus would assert is evidence that a portion of debt claimed by MNEs is artificial, for the purposes of avoiding paying tax).[81]

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[77] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 21.
[78] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 11.
[79] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 17.
[80] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 17.
[81] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris,

However, the OECD has acknowledged that unilateral approaches have been successful to varying degrees, "but there is a sense that unilateral action by countries is failing to tackle some of the issues at the heart of the problem."[82] TJN-Aus supports the Australian Government taking its own action in domestic law to address the issue, but sees this as only part of the solution. Multilateral collaboration will also be needed, which will take longer. However, immediate domestic action should not put off while long term multilateral collaboration is secured.

The OECD has pointed out that it has:[83]

> *"become increasingly apparent that a consistent approach utilizing international best practices would be a more effective and efficient way of addressing concerns surrounding the use of interest in base erosion and profit shifting. This approach should encourage groups to adopt funding structures whereby: (i) net interest expense of an entity is linked to the overall net interest expense of an entity is linked to the overall net interest expense of the group; and (ii) the distribution of a group's net interest expense should be linked to income-producing activities. Groups should also benefit from a consistent approach between countries. Similar rules based on the same principles should make the operation of rules more predictable, enabling groups to plan their capital structures with greater confidence. It could also make it possible to introduce group-wide systems and processes to produce required information, making compliance with rules in multiple countries simpler and cheaper. A consistent approach should remove distortions, reduce the risk of unintended double taxation and, by removing opportunities for base erosion and profit shifting, improve fairness and equality between groups."*

The TJN-Aus urges the Australian Government to support moves internationally to apply a formulaic apportionment of debt across a multinational company based on the substance of its operations rather than on artificial legal structures designed to avoid paying tax and to engage in debt-equity arbitrage. Such an approach, of treating the multinational as a unitary entity, has been advocated by the BEPS Monitoring Group, made up of specialists on various aspects to international tax.[84] As they point, the 'separate entity' principle when dealing with multinational companies:[85]

> *…creates perverse economic incentives which will continue to drive the creation of complex structures and use of elaborate transactions exploiting differences between national laws. The only effective way to end this pointless and wasteful game is to deal with the root of the problem, the strong motivation for BEPS created by the separate entity principle.*

This view has been shared by Associate Professor Antony Ting from the University of Sydney Business School, who wrote in July 2014:[86]

2015, p. 17; and Chloe Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach", *World Tax Journal,* February 2014, pp. 44-45.

[82] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 17.

[83] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 18.

[84] BEPS Monitoring Group, 'Neutralising the Effects of Hybrid Mismatch Arrangements', 2 May 2014, p. 3.

[85] BEPS Monitoring Group, 'Neutralising the Effects of Hybrid Mismatch Arrangements', 2 May 2014, p. 3.

[86] Antony Ting, 'Hockey to tighten tax laws for multinationals but loopholes still exist', *The Conversation* 4 July 2014.

> *The fundamental problem of the thin capitalisation regime is that instead of recognising the reality that a multinational operates as one single enterprise, the tax law insists on treating each company as a separate taxpayer. This means it fails to consider that the group as a whole bears lower or even no interest expenses. It will continue to allow deduction of intra-group expenses that are created artificially for tax avoidance purposes.*

The OECD also pointed out that the intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules. They recommended that governments should "limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on funding provided and require group synergies to be taken into account when evaluating intragroup financial payments."[87] The OECD points out they are undertaking further work on the transfer pricing aspects of financial transactions during 2016 and 2017.

The Committee should ask the ATO:

- How extensive does the ATO believe it is for multinational enterprises operating in Australia to have their assets in Australia over-valued for the purpose of being able to load up entities in Australia with debt and remain under the safe-harbour thresholds in the thin capitalisation rules of the *Tax and Superannuation Laws Amendment (2014 Measures No 4) Act 2014*? How many companies has the ATO encountered where they have reasonable grounds to suspect this activity is occurring?
- On a year by year basis, how many times in the last five years has the ATO challenged a multinational enterprise over its interest payment deductions, where the multinational enterprise has a debt-to-equity ratio less than the safe harbor limit?

[87] OECD, 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report', OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p. 13.

4. Limiting Deductions to Secrecy Jurisdictions

Multinational enterprises can avoid tax by claiming manipulated transactions with secrecy jurisdictions that have low or no tax on the transaction in question, or have cut a special deal with the multinational enterprise that is concealed from the ATO to pay lower taxes in general or on specific types of transactions.

'Secrecy jurisdictions' provide laws and regulations that offer secrecy to those conducting transactions across their borders. They undermine the ability of other governments, elected by their citizens, to levy taxes in a just and fair way, by providing a loophole for the wealthiest to escape paying their fair share of tax. Global good governance is undermined when governments choose to act as 'secrecy jurisdictions'.

While many 'secrecy jurisdictions' are also defined as 'tax havens', the definitions of the two are different. The Australian Taxation Office (ATO) has also used the language of 'secrecy jurisdictions'.[88]

The definition of a secrecy jurisdiction is in three parts.[89] Firstly, secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. It must deliberately create laws that wholly or mainly relate to activities that take place 'elsewhere' as far as it is concerned.

Secondly, a secrecy jurisdiction deliberately designs the regulation they create for use by people who do not live in their territories so that it undermines the legislation or regulation of another jurisdiction.

Thirdly, the secrecy jurisdiction creates a deliberate, legally backed veil of secrecy that ensures those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. While all three of these characteristics must be present for a country to be considered a secrecy jurisdiction, this third characteristic is the most important.

We recognise that there can be legitimate reasons for a multinational company locating a subsidiary in a secrecy jurisdiction. However, at the same time choosing to set up companies in a secrecy jurisdiction, when other choices exist, can reward the government of that jurisdiction for maintaining laws that can facilitate tax evasion, money laundering and tax avoidance. It can also undermine corporate transparency and accountability more broadly.

The ATO reported that in 2012 Australian tax payers that submitted International Dealing Schedules had financial transactions with the following secrecy jurisdictions:[90]

- Andorra;
- Anguilla;
- Antigua and Barbuda;
- Aruba;
- Bahamas;
- Bahrain;
- Belize;
- Bermuda;
- BVI;
- Dominica;
- Gibraltar;
- Grenada;
- Guernsey;
- Isle of Man;
- Jersey;
- Liberia;
- Liechtenstein;
- Marshall Islands;
- Nauru;
- Panama;
- Saint Kitts and Nevis;
- Saint Lucia;
- Saint Martin (Dutch part);
- Saint Vincent and the Grenadines;
- Samoa;
- San Marino;
- Seychelles;

[88] Australian Taxation Office, 'Compliance Program 2011-12', June 2011, pp. 25, 33.
[89] Tax Research LLP, 'Research Briefing – Secrecy Jurisdictions', Financial Integrity and Economic Development Task Force, Tax Justice Network, Tax Research UK, September 2010, http://www.taxresearch.org.uk/Documents/Secrecyjurisdiction.pdf
[90] ATO Document 7 of FOI release to the Synod of Victoria and Tasmania Uniting Church in Australia, IDS external overview, undated.

- Caymans;
- Cook Islands;
- Curacao;
- Mauritius;
- Monaco;
- Montserrat;
- Turks and Caicos Islands;
- US Virgin Islands; and
- Vanuatu

The ATO has noted that between 2005 and 2011 there was a 49% increase in the number of controlled entities in havens and low tax jurisdictions by ASX100 entities.[91]

AUSTRAC analysis of fund movements to and from selected secrecy jurisdictions found that in 2012-13 $60 billion flowed into Australia from secrecy jurisdictions, while $47 billion flowed out of Australia.[92] AUSTRAC figures for 2012–13 show less money was sent from Australia to overseas tax secrecy jurisdictions such as Vanuatu, Liechtenstein and Jersey than was sent five years ago.[93]

In May 2013, the ATO revealed they had substantial data which reveals extensive use of complex offshore structures to conceal assets by wealthy individuals and companies. The data reveals complex offshore structures in a number of jurisdictions around the world including Singapore, British Virgin Islands, Cayman Islands and Cook Islands.[94] The ATO stated: "There is nothing illegal about an international structure, especially in a globally integrated economy. However, offshore structures are often used for false loans, inflated tax deductions, hiding assets and other arrangements to avoid or evade tax liabilities."[95]

In November 2012, the ATO revealed:[96]

> *In a recent transfer pricing audit, we examined a multinational enterprise claiming deductions for very large amounts of royalty and service fees. Our initial enquiries to the taxpayer revealed that they had transferred intellectual property to the Netherlands for several billion dollars and this was the source of the large deduction.*
>
> *When we asked about the treatment of the intellectual property by the parts of the group operating in other jurisdictions, we were assured the treatment was consistent across jurisdictions. As it turned out, following an Exchange of Information request with the US, UK and Netherlands, this transfer value was not in accordance with a cost sharing agreement in another jurisdiction and, as a result, we are challenging this inconsistency.*

The ATO has stated that in terms of the use of secrecy jurisdictions:[97]

> *Foreign and Australian based MNEs use offshore arrangements to inappropriately transfer profits from Australia to related offshore party hubs which:*
>
> - *Centralise functions and associated risks in an entity in a low tax jurisdiction where: a high value is attributed to the function; or the risks have been legally assigned to, but not fully assumed by the entity; or the entity has little or no ability to control these risks.*

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[91] Australian Taxation Office, 'Corporate Transparency Overview', September 2013, p. 12.
[92] Australian Taxation Office (2014), *ATO Annual Report 2013-14*, p. 61.
[93] AUSTRAC (2014*), AUSTRAC Annual Report 2013-14,* p. 63.
[94] Australian Taxation Office, 'No safe havens', ATO Media Centre, 10 May 2013, https://www.ato.gov.au/Media-centre/Media-releases/No-safe-havens/
[95] Australian Taxation Office, 'No safe havens', ATO Media Centre, 10 May 2013, https://www.ato.gov.au/Media-centre/Media-releases/No-safe-havens/
[96] Bruce Quigley, 'Tax administration in a global environment', Sydney, ATO Media Centre, 22 November 2012, https://www.ato.gov.au/Media-centre/Speeches/Other/Tax-administration-in-a-global-environment/
[97] Australian Taxation Office, 'Offshore hubs mitigation strategy overview', 17 July 2014, p. 4.

- *Involve the related entity in the low tax jurisdiction purporting to provide such value add activities to the Australian taxpayer for a significant fee which does not result in outcomes expected or observed between arm's length parties.*
- *Result in profit in Australia not being taxed, or the exclusion of profits that were previously taxed in Australia, where this is not commensurate to the level of economic activity that takes place in Australia.*
- *Where the transfer of function or risks is involved, the transfer does not appear to have a commercial justification, or does not appear to be to the benefit of the Australian taxpayer.*

In terms of the action the ATO has taken in response to MNEs using subsidiaries in secrecy jurisdictions:[98]

> *Under the ISAPS [International Structuring and Profit Shifting] initiative, the profit shifting risk models have led to the creation of over:*
> - *50 cases with restructuring issues; and*
> - *100 cases with profit shifting issues that can include pricing issues in relation to the use of offshore hubs.*
>
> *There are also an additional 20 cases under review, audit or APA [Advance Pricing Agreement] negotiations with known marketing or procurement hub issues. While initial intelligence from these cases indicates that we are still seeing the implementation and use of marketing hubs, there is also evidence of the use of procurement, logistics/shipping, intellectual property and financial hubs respectively. Intelligence also indicates that individual MNEs may have more than one hub structure in operation.*

The ATO has indicated that Australia's general anti-avoidance rule, Part IVA, is not likely to be effective in combating MNEs engaged in tax avoidance activities through the use of subsidiaries in secrecy jurisdictions:[99]

> *In most cases the business (re)structure is business initiated and driven. Intelligence from compliance activity indicates that Part IVA is likely to be ineffective in many cases. However, there will be cases involving how the hub is structured, or where the particular critical step in the restructure cannot be explicable by non-tax commercial reasons, where the structure will be susceptible to challenge under Part IVA.*

The TJN-Aus believes the Australian Government should follow the lead of jurisdictions that have disallowed deductions with respect to transactions with residents of a jurisdiction that does not effectively exchange information with their tax authority (which is already used by Argentina, Brazil, Germany, India and Italy). Such a measure would provide substantial incentive for any jurisdiction not intentionally providing secrecy to multinational enterprises operating in Australia to enter into information exchange agreements with the ATO.

A jurisdiction would not be subject to the disallowed deductions if the Commissioner of Taxation indicates it has in place sufficient measures to exchange information with the ATO, such as a functional Tax Information Exchange Agreement (TIEA). As of 13 January 2016 the Australian Government has 37 TIEA's in place, many are with secrecy jurisdictions. Jurisdictions where there is not a TIEA in place include Curacao, Nauru, Panama, and Seychelles. Key jurisdictions like Switzerland, Singapore and Hong Kong are not covered by TIEAs, but other specific bilateral agreements may exist. Jurisdictions might also share information with the ATO through the OECD *Convention on Mutual Administrative Assistance in Tax Matters,* which Singapore and Switzerland have signed, but have not yet taken the necessary steps to bring the provisions of the Convention into force within their jurisdiction.

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[98] Australian Taxation Office, 'Offshore hubs mitigation strategy overview', 17 July 2014, pp. 6-7.
[99] Australian Taxation Office, 'Offshore hubs mitigation strategy overview', 17 July 2014, pp. 7-8.

5. Neutralise the effects of Hybrid Mismatch Arrangements

The TJN-Aus is concerned about the use of hybrid mismatches, for example where Australia might treat a financial instrument as debt and allow a deduction for the interest charged, while the jurisdiction where the interest payment is sent treats the financial instrument as equity and therefore does not tax the interest. The underlying problem is that interest expenses are generally considered as deductible from business profits, so reduce the tax base in source countries, while tax treaties limit the power to levy withholding taxes at source on interest payments. However, this may apply even if such payments are not taxed as income of the entity receiving them (deduction with no inclusion). In the Chevron case above an example of this was provided, where Chevron has been able to claim interest payments as tax deductions in Australia and not pay any tax on the same payments in the US. Further, companies can organize their financial structure so as to obtain a deduction in two countries (double deduction or `double dipping'). The OECD has pointed out that hybrid mismatch arrangements not only impact on tax revenue, but also have a negative impact on efficiency, transparency and fairness.[100] The OECD BEPS Action 2 considered this problem. Action 2 dealt only with where either the entity or the instrument are `hybrids', that is treated differently by the law in the two countries.[101]

For domestic law the OECD proposed that governments should make sure:[102]

- Domestic law denies a dividend exemption, or equivalent relief from economic double taxation, in respect of deductible payments made under financial instruments.
- They have measures in place to prevent hybrid transfers being used to duplicate credits for taxes withheld at source.
- They alter the effect of controlled foreign corporation (CFC) rules and other offshore investment regimes to bring income of hybrid entities within the charge to taxation under the laws of the investor jurisdiction.
- Encourage countries to adopt appropriate information reporting and filing requirements in respect of tax transparent entities established within their jurisdiction.
- Restrict the tax transparency of reverse hybrids that are members of a control group.

Table 1. General overview of domestic law reforms recommended by the OECD to address hybrid mismatches.[103]

Mismatch	Arrangement	Specific recommendation on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
Deduction/ Non-Inclusion	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny tax-payer the deduction	Include as ordinary income	Related parties and structured arrangements

[100] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report", OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p.15.
[101] BEPS Monitoring Group, 'OECD BEPS Scorecard', October 2014, p. 5.
[102] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report", OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p.16.
[103] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report", OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p.20.

	Disregarded payment made by a hybrid		Deny tax-payer the deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to a reverse hybrid	Improvements of offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny tax-payer the deduction		Control group and structured arrangements
Double Deduction	Deductible payment made by a hybrid		Deny tax-payer the deduction	Deny tax-payer the deduction	No limitation on response, defensive rule applies to control group and structured arrangements
	Deductible payment made by dual resident		Deny tax-payer the deduction		No limitation on response
Indirect Deduction/ Non-Inclusion	Imported mismatch arrangements		Deny tax-payer the deduction		Members of control group and structured arrangements

The OECD has pointed out that hybrid mismatch rules are generally intended to pick-up mismatches that are attributable to difference in the value ascribed to a payment. For example, gains and losses from foreign currency fluctuations on a loan can be said to give rise to mismatches in tax outcomes, but these mismatches are attributable to differences in the measurement of the value of payment (rather than its character) and can generally be ignored for the purposes of the hybrid mismatch rules.[104]

The OECD proposed scheme provides that generally the source state would be allowed to refuse a deduction if, or to the extent that, the payment concerned is not taxed by the receiving state; but if it does not do so, the receiving state may tax it. The measures are considered to be complementary, so capable of application without any need for coordination. Some have argued that the recipient should have the primary jurisdiction to tax, but the OECD has decided that the source state should have first bite; rightly, in our view, as it has the stronger incentive to ensure tax is levied.[105]

[104] OECD, “Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report”, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p.18.
[105] BEPS Monitoring Group, ‘OECD BEPS Scorecard’, October 2014, p. 5.

On the issue of hybrid mismatch arrangements, in September 2014 the ATO stated:[106]

> *Whilst Australia has a number of audit cases involving potential hybrid instrument and entity mismatch arrangements, we do not currently have anti-hybrid mismatch rules. We are currently seeking feedback from our operations teams to identify and consolidate examples of hybrid mismatch in order to establish the level of risk, before identifying any potential action required.*

However, it is of some concern that:[107]

> *Both the ATO and Treasury support the approach that the rules should only apply to deliberate mismatches (for example, related party and structured arrangements) and exclude unintended mismatches.*

The TJN-Aus is not clear that there is a strong line between a clear deliberate mismatch and one that was not intended. Such an approach has the potential to invite tax planners to devise and promote schemes that appear to be unintended mismatches.

Therefore TJN-Aus supports the view that the Australian Government should introduce legislation to allow the Commissioner for Taxation the ability to deny a deduction where a foreign jurisdiction does not treat the income from the deduction as taxable income at their end or the other jurisdiction allows it to be a deduction in their jurisdiction as well (a double deduction).

Once a MNE enters into a hybrid mismatch arrangement between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter for the effect of that mismatch to be shifted into a third jurisdiction (through the use of an ordinary loan, for example).[108] Therefore, the TJN-Aus supports the OECD recommendation that deductions be denied for a payment where the payee sets the income from that payment off against expenditure under a separate hybrid mismatch arrangement.[109]

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[106] Mark Konza, 'Base erosion and profit shifting – a progress report on G20/OECD action', Melbourne, ATO Media Centre, 25 September 2014, https://www.ato.gov.au/Media-centre/Speeches/Other/BEPS---a-progress-report-on-G20/OECD-action/
[107] Mark Konza, 'Base erosion and profit shifting – a progress report on G20/OECD action', Melbourne, ATO Media Centre, 25 September 2014, https://www.ato.gov.au/Media-centre/Speeches/Other/BEPS---a-progress-report-on-G20/OECD-action/
[108] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report", OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p.17.
[109] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report", OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, p.15.

Appendix: Background on the Tax Justice Network Australia

The Tax Justice Network Australia (TJN-Aus) is the Australian branch of the Tax Justice Network (TJN) and the Global Alliance for Tax Justice. TJN is an independent organisation launched in the British Houses of Parliament in March 2003. It is dedicated to high-level research, analysis and advocacy in the field of tax and regulation. TJN works to map, analyse and explain the role of taxation and the harmful impacts of tax evasion, tax avoidance, tax competition and tax havens. TJN's objective is to encourage reform at the global and national levels.

The Tax Justice Network aims to:
(a) promote sustainable finance for development;
(b) promote international co-operation on tax regulation and tax related crimes;
(c) oppose tax havens;
(d) promote progressive and equitable taxation;
(e) promote corporate responsibility and accountability; and
(f) promote tax compliance and a culture of responsibility.

In Australia the current members of TJN-Aus are:

- ActionAid Australia
- Aid/Watch
- Australian Council for International Development (ACFID)
- Australian Council of Trade Unions (ACTU)
- Australian Education Union
- Anglican Overseas Aid
- Baptist World Aid
- Caritas Australia
- Columban Mission Institute, Centre for Peace Ecology and Justice
- Community and Public Service Union
- Friends of the Earth
- GetUp!
- Global Poverty Project
- Greenpeace Australia Pacific
- International Transport Workers Federation
- Jubilee Australia
- Maritime Union of Australia
- National Tertiary Education Union
- New South Wales Nurses and Midwives' Association
- Oaktree Foundation
- Oxfam Australia
- Save the Children Australia
- SEARCH Foundation
- SJ around the Bay
- Social Policy Connections
- Synod of Victoria and Tasmania, Uniting Church in Australia
- TEAR Australia
- Union Aid Abroad – APHEDA
- UnitedVoice
- UnitingWorld
- UnitingJustice
- Victorian Trades Hall Council
- World Vision Australia