Chevron's landmark loss against ATO sets a precedent

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The Australian Tax Office (ATO) will go after other multinationals that it believes to be guilty of tax avoidance after winning a landmark transfer pricing case against global oil and energy company Chevron over shifting profits to the US.

The Federal Court of Australia dismissed Chevron's appeal against an earlier ruling and the company now faces a tax bill of more than A$300 million ($226 million) for trying to lower its tax bill by using a series of inter-company loans and related-party payments.

"Chevron will pay more than A$300m to the ATO, proving the government's programme of tax avoidance funding and new measures is working," Treasurer Scott Morrison tweeted after the ruling.

The latest decision sets a ground-breaking precedent on the pricing of related party cross border loans, which will affect all taxpayers with an Australian interest.

"Not surprisingly, the court's decision seems to have put wind into ATO sails," said Adrian O'Shannessy, director of Greenwoods & Herbert Smith Freehills. "It plans a 'Decision Impact Statement' apparently even ahead of any High Court appeal. I'm also led to believe, but have been unable to confirm, that cross-border loan pricing is now a number one ATO focus area given the volume of dollars potentially involved. It was always high on the agenda."

"Subject to the outcome of any appeal by Chevron to the High Court of Australia, the estimated A$420 billion of related party borrowings between Australian subsidiaries and their overseas parents and the billions of dollars in deductible interest payments relating to these borrowings will continue to be carefully scrutinised by the ATO," said Martin Caplice, Oceania leader of tax controversy at EY in Sydney. "Further adjustments assessing multinationals to tax and penalties and subsequent litigation is likely."

"The decision has international relevance because it is one of the first transfer pricing cases globally to look at the arm's length pricing of money in the context of intercompany loans," he continued. "Taxpayers will need to carefully consider the documentation of their inter-company finance arrangements, with particular reference to the interest rate applied and how those arrangements are put into evidence before a court."

Chevron's dispute

The ATO issued several tax assessments to Chevron for five tax years from 2004 to 2008 because it believed that intra-group loans between Chevron Australia Holdings Pty Ltd (CAHPL) and its US subsidiary, set up to lend funds to its Australian parent, were not at arm's length. It also argued that the arrangements allowed CAHPL to claim excessive tax deductions in Australia.

A credit facility agreement, established in 2003, saw CAHPL pay interest to Chevron Texaco Funding Corporation at a rate of about 9%. Chevron Texaco Funding Corporation (CFC), meanwhile, made use of Chevron's investment grade credit rating to borrow in the US at a rate of 1.2%. The internal financing structure resulted in the profits made by the subsidiary not being taxable in the US. The effect of the interest payments also created a tax deduction for the Australian entity against its operating revenue from its interest, through subsidiaries, in the North West Shelf gas project.

Further, the interest as income in the hands of the US entity was not taxable in the US because CFC was a wholly owned foreign subsidiary of CAHPL. Moreover, the dividends declared by CFC from the profits made in the US were not assessable income in the hands of CAHPL.

"What is interesting is the fact that the US company receiving the interest is seemingly not liable to tax there - presumably as a result of structuring to benefit from the US check-the-box regime. In other words, Chevron got a 'double dip' – tax deduction in Australia and no pick up in the US," said Miles Dean, founding partner of Milestone International Tax Consultants. "This 'double dipping' used to be relatively easy to achieve by playing differences in the national tax rules. The OECD is clearly trying through its Base Erosion and Profit Shifting (BEPS) initiative to ensure that it becomes very difficult to do."

Chevron Australia disputed the ATO's assessments, arguing that its financing is a legitimate business arrangement. The two parties failed to reach a resolution and the issue went to court.

"The ATO assessments relied on Australia's general cross-border transfer pricing regime at the time, but also in the alternative on some reinforcement rules (Division 815-A) legislated retrospectively," said O'Shannessy. "Chevron challenged these rules on the basis that it could not have known the (additional) basis for taxation in the years of income. Australia's constitution invalidates arbitrary taxation because it would effectively allow parliament to decide its own authority. So the criteria for a tax must be general in application and clear. A retrospective tax is unknown in the year in which it applies, let alone clear, and it's perhaps also arbitrary to wait and see what happens before designing your tax to suit. The court dismissed the challenge, but not convincingly."

The Federal Court ruling

In the latest ruling on this dispute, Judges Tony Pagone CJ Allsop and Perram upheld the earlier decisions, stating that Chevron's financing arrangements allowed it to make "significant profits from borrowing at 1.2% and on-lending at 9% which would not be taxed either in the US or in Australia". The court found in favour of the ATO, saying Chevron failed to show that the ATO's assessments were excessive and unfair.

"The Federal Court with its latest Chevron decision has set ground-breaking precedent on the pricing of related party cross-border loans, with ramifications not just for Australian taxpayers," said O'Shannessy. "The Court held again for the Tax Commissioner, against Chevron, and ruled on two key international tax standards for cross-border transactions: the requirements to price 'at arm's length', and as 'independent enterprises' – standards common to all OECD based tax systems. Multinational groups worldwide rely on the efficiency and flexibility of cross-border loans to fund their operations."

"Chief Justice Allsop made it clear that an interest rate of 9% charged by Chevron on its intercompany debt was excessive," said Caplice. "The main reason for this was that in determining what the arm's length interest rate should be, the court could not ignore on the facts as they saw it the commercial reality that Chevron's subsidiary borrower was part of a group that had a policy to borrow externally at the lowest cost in circumstances where that borrowing was generally guaranteed by the parent for no consideration. The Full Federal Court also held that it would be unrealistic for it to do so."

"There is an inherent good sense in the Court's decision, the ATO would say, because the group's cost of the funds used to finance its Australian operations was below 2%, and yet it claimed Australian income tax deductions at 9%. Part of that difference was due to the currency switch, but not all of it," said O'Shannessy.

A spokesman for Chevron said it was disappointed in the Federal Court's decision and will review the ruling to determine the next steps, which may include an appeal to the High Court of Australia. "As recognised by the trial court in the dispute, the financing is a legitimate business arrangement and the parties differ only in their assessments of the appropriate interest rate to apply."

Ruling provides guidance on transfer pricing laws

The Federal Court's decision significant guidance on both the old (Division 13) and new (Sub-division 815-A) transfer pricing laws in Australia under the Income Tax Assessment Acts of 1936 and 1997, as applicable to cross-border financing arrangements.

"Whilst the decision deals with certain administrative, constitutional and procedural issues, the decision is most important in terms of determining the arm's-length consideration (particularly, interest rates) applicable to cross border loans," noted Jock McCormack, head of tax at DLA Piper in Sydney. "The two principal judges effectively imputed a parent company guarantee to the loans in order to determine the arms-length consideration applicable to these loans, resulting in lower effective interest rates."

"Division 13 in particular, requires a hypothetical analysis to determine what consideration (interest rates) would reasonably be expected to be paid under the loans. It is critical that the hypothetical/comparable arrangement is explored on the basis that the relevant parties (i.e. lender and borrower) are independent and are dealing at arms-length with one another," McCormack continued. "Given amongst other things, Chevron Group's borrowing policies, the court believed an independent borrower would have given some security and operational and financial covenants."

"Chevron's loan was unsecured and without normal borrower covenants, which Chevron said justified a much higher interest rate, and therefore higher tax deductions in Australia. The court said, however, that if the taxpayer had borrowed at arm's length, more normal commercial terms could have been expected, and therefore a lesser interest rate would have applied," O'Shannessy said. "Ironically, the court also said that in an arm's length situation the taxpayer could be expected to rely on at least implicit Chevron US parent support, which would also reduce the interest rate. The requirement to price as an independent enterprise, therefore, is not quite to be taken literally. Instead, it means price as if an independent enterprise stands in the shoes of the lender. This point might be tested in the future though, in the case of a loan by a parent to a subsidiary. The loan here was from subsidiary to parent. Both points though are important strategic wins for the Australian Tax Commissioner, who has audited on this basis for some time now."

Multinationals should take note

A last resort, Chevron could appeal to the High Court, but O'Shannessy said the court would need to grant leave for this strategy to work, and it often doesn't. "Subject to that, which could be months away, many multinational groups are likely to be reviewing the case closely."

"If we assume for a moment that the High Court of Australia upholds the reasoning of the four Federal Court judges who have so far examined the case, there may be a number of tax directors and CFOs of large multinationals increasing the provisions recorded in their financial statements for potential exposure to additional Australian taxes for interest deductions disallowed in respect of their intercompany financing arrangements. Ultimately, the facts underpinning the intercompany financing arrangements of those other multinationals will be critically important," said EY's Caplice.

"Whilst the ATO is keen to bask in the glory of the Full Federal Court decision and to use it as a basis to pursue purportedly aggressive intercompany financing structures, there may well be an appeal of this decision to the High Court of Australia," Caplice continued. "Regardless of that outcome, there will be further judicial consideration of the Australian transfer pricing rules in the near future. Each matter will be determined on its own facts and it will be critical in any future litigation that taxpayers very carefully consider the evidence in support of their pricing, including any expert evidence, and the manner in which that it is presented to a court."

McCormack believes Chevron will appeal the decision, but said other multinationals should review their own arrangements now.

"While the decision would appear to provide broader precedent for the general application of Australia's general transfer pricing laws, all multinationals should review their current international loan arrangements in the context of this decision. In this context, if security arrangements are to be imputed it may be that a deductible fee can be included for provision of security/support by the ultimate parent company (based on the alternative submission of Chevron Group)."

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