Governments worldwide have declared war against transfer pricing (TP), a method under which tax risks are increasing day-by-day.

The tax authorities have greater resources and more power than ever before, and tax inspectors are better trained and more skilled.

The tax authorities will protect their own tax base and they have shown clearly that they have the power and willingness to challenge businesses. The GlaxoSmithKline settlement is just one example of a corporation which is facing tax adjustments amounting to billions of dollars.

There is no clear hierarchical ranking between different sources in respect of international taxation. For example, if there is a conflict between a pipeline and a tax treaty, which one will prevail?

Treaties are written in general terms and need to be interpreted, and the tax authorities are aiming to interpret such treaties in their own favour, thus resulting in higher risks for taxpayers.

The allocation of income between countries is extremely complex and tax treaties contain few specific guidelines for the petroleum industry. The allocation of income from a cross-border pipeline between several countries could be an impossible task; it is also easy for the tax authorities to challenge such allocations.

Multi-national businesses face much higher tax risks than ever before. Cross-border pipeline operators are no exception, as such businesses may even face higher tax risks than average corporations. These increased tax risks are due to several factors:

Cross-border pipeline operators may face significant and various tax risks even though the governments involved have signed pipeline agreement(s) or the operating company has signed a pipeline contract with the government concerned. These tax risks need to be dealt with as they will not disappear, but rather increase.

There have been, and still are, financial crises in many countries, and governments desperately need more revenue. Where will they search for such revenue? Probably among highly profitable corporations such as pipeline operators.

A pipeline operator might have a contract with the government, but such a contract is only a legal agreement between the operator and the government, and domestic legislation will probably prevail in the event of conflict. If a pipeline contract conflicts with a tax treaty or a pipeline treaty, a foreign government will probably completely ignore the contract and its contents.

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There are some, but not all, of the factors that could create significant tax risks, and the next step is to consider the specific tax risks these factors create.

There is always a risk that the tax authorities in one or several countries will challenge the arms’-length price agreed between the parties involved, the chosen transfer-pricing (TP) method, the documentation provided, or the different tax policies concerned. This could lead to significant tax adjustments being made in one or several countries.

There is always a risk that the other state involved might disagree with the adjustments made in the first country and would not want to make corresponding adjustments, which normally involves a risk of double taxation.

The pipeline operation company could face time-consuming disputes with one or several tax authorities and even expensive and never-ending litigation. There is also a risk that the company would have to pay the tax in full – in both countries – even if such disputes continue for years.

There is a risk of late-interest fees being imposed, although this is not one of the highest risks.

There is a risk of significant tax penalties applying not just in one country, but in all the countries where the company concerned operates the pipeline in question. The tax penalties vary, and some countries apply tax penalties of up to 300-400%, which are also non-deductable.

Some tax authorities can make adjustments up to ten years in arrears, and the risks and consequences involved could therefore be considerable.

Pipeline operators face a significant number of risks, including damage risks, reputation risks, entrepreneur risks, environment risks, and health and safety risks, as well as tax risks, and all these risks could affect a business’ bottom line. However, the tax risks could be one of the three highest risks that a pipeline operator may have to face.

Not all corporations take these high tax risks seriously enough. Some corporations might believe that pipeline agreements, tax treaties, or the pipeline contract will be adequate for dealing with such issues, but this is not always the case. Some tax managers might be too busy with other issues and not have enough time for engaging in tax risk management and tax risk mitigation. Some might think that they do not need to worry because they have never had a tax inspection, or their last inspection went well. But they should worry.

So far, we have acknowledged that pipeline operators have significant tax risks and that such tax risks could affect their bottom line in a very negative way. The next step is to consider the type of remedial action that corporations could take in order to mitigate these risks.

Some might think that they do not need to worry because they have never had a tax inspection, or their last inspection went well. But they should worry.

The first step is to recognise and accept that the corporation concerned is exposed to significant tax risks. The second step is to be prepared for a tax inspection, or the unthinkable. In order to be prepared, corporations should establish a proper tax-risk management system under which they identify, analyse, prioritise, and mitigate any tax risks as far as reasonably possible. Pipeline operators should consider the text contained in any tax clauses in concluded pipeline agreements or contracts. Not all such agreements or contracts include detailed text about taxation and tax conflicts, and some parts of a treaty or contract may sometimes create more uncertainty than certainty. They should then consider which source will prevail in the event of a conflict – the pipeline agreement, the tax treaty, or perhaps some other source?

They need to consider whether the pipeline concerned is regarded as being a permanent establishment, which was the case in The German Pipeline Case and in The West African Gas Pipeline Treaty? Furthermore, they need to consider whether they can defend the allocation of income that they have made between countries and also whether there are any TP issues that might require further attention. For example, do they have proper TP policies and documentation and are the transactions in line with the policies? What about transit in pipelines crossing the exclusive economic zone or the continental shelf of another country? Has the pipeline operator considered the tax implications of such transportation in enough detail, or are there any significant tax risks of which that they are not aware?

Implementing a quality system and achieving ISO 9001 certification for the tax issues related to cross-border pipeline transportation is another way in which tax risks can be mitigated.

Unfortunately, not all petroleum businesses are prepared for such high tax risks and they may be surprised if, or perhaps we should say when, they are subjected to a tax inspection. Tax risks are all about uncertainty, predicting the unthinkable, and being prepared. Remember, the Board of Directors and other stakeholders do not want any unpleasant surprises such as tax adjustments, double taxation, penalties, and time-consuming, costly disputes with the tax authorities or litigation.

References
1. GlaxoSmithKline was forced to accept a settlement with the US Internal Revenue Service (IRS) in 2006 under which the company had to pay US$3.4 billion and also had to abandon a tax refund of US$1.8 billion.
3. The German Pipeline case, decision of 30 October 1996, II R 12/92 BetriebsBerater 1997. The pipeline was considered as a permanent establishment in Germany despite the fact that there were no employees and that the pipeline was operated automatically in Germany. As the Supreme Court decided that it was a permanent establishment, the company was subjected to tax liabilities in Germany.

For further information about Dr K Olsen Global Tax Consultant, please see www.knutolsen.com. The topics in this article are covered more thoroughly in Prof. Olsen’s book entitled Characterisation and taxation of cross-border pipelines (IBFD).