Weakness, Uncertainty and Risk for the Petroleum Industry Related to Allocation of Income According to OECD Model Tax Treaty Articles 7 and 9 by K. Olsen

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Weakness, uncertainty and risk for the petroleum industry related to allocation of income according to OECD Model Tax Treaty Articles 7 and 9

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Abstract

The intention of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishment (the Attribution Report) was to establish an authorized approach for the attribution of profits, and they succeeded. The authorized approach for attribution of income and expenses is applicable to all industries, as well as for subsidiaries. However, as the report is written in very general terms, it is not particularly useful for the petroleum industry. Rather the opposite - it could create even more uncertainty, disputes, tax risks and possible tax adjustment, penalties and, perhaps, double taxation. Even if the petroleum industry makes significant attempts to fulfill these requirements, it will be easy for the tax authorities to challenge the industry, mainly because the authorized approach is too diffuse. The petroleum industry would benefit, therefore, from more detailed and specific guidelines, specifically designed for the industry. Unfortunately, the OECD’s process for establishing new guidelines is time consuming and it could take years before the OECD publishes specific guidelines that are more applicable for the petroleum industry. It might even take years before the OECD recognizes the need and starts the process for establishing such guidelines.

1. Introduction

The OECD’s authorized approach for attribution of income is written in general terms. It is theoretical and not applicable to the petroleum industry, even so the industry has to apply these general terms, in spite of the fact that it would benefit from more specific guidelines. As will be explained, this situation might lead to uncertainty for both the petroleum industry and the tax authorities, which could lead to dispute, significant tax risks and possibly tax adjustment, penalties and double taxation, even when the industry makes significant attempts to attribute income and expenses correctly. Therefore, there is an urgent need for more specific guidelines for the petroleum industry.

1 OECD, 2010 Report on the Attribution of Profits to Permanent Establishment 22.7.2010
2. Weaknesses in OECD Guidelines for attribution of income

There is an urgent need for thorough guidance on the attribution of income and expenses in the petroleum business with particular emphasis on Article 7 and 9 in the OECD’s Model Tax Treaty, which is laid down in OECD, 2010 Report on the Attribution of Profits to Permanent Establishment. There are several reasons why the OECD 2010 Report is not fulfilling its purpose:

i) The Attribution Report established ‘the functionally separate entity approach’ and it gives guidelines for the attribution of income and expenses. The guidelines are general and are extremely difficult to implement for the petroleum industry.

ii) There are uncertainties in the authorized approach as it is written in general terms and is open to different approaches and interpretation without giving preference to one single approach.

iii) The Attribution Report requires that income-generated assets shall be attributed between countries. One example is all the costs related to a terminal or a pumping station in one country must be allocated between the countries that create income from these assets. This is a very complex exercise.

iv) Further, the report requires that the cost of any risk must be estimated for each country and allocated to each subsidiary or permanent establishment. As described below, the risks the petroleum company might face are also extremely complex and almost impossible to estimate.

v) The Attribution Report requires that necessary ‘free’ capital (equity) must be estimated and attributed to the different countries. Estimating the necessary ‘free’ capital that must be attributed to each country is again close to impossible for the petroleum sector.

vi) All these issues mean that the petroleum industry needs to make several estimates, estimates based on uncertainties, as the OECD’s authorized approach is couched in general terms and does not explain exactly how these estimates should be calculated and attributed.

vii) It is uncertain whether the tax authorities will accept calculations made by the industry, based on weak guidelines and the lack of a recommended approach, combined with the possibility of choosing from several possible approaches. The current situation undermines confidence because the estimations are extremely complex. Transfer pricing is an art which has no certain answer. Even if a company makes a significant effort with the calculation of the attribution, there is a significant risk that the tax authorities in one or other country will challenge the calculation. Even small adjustments in the transfer price could lead to significant tax adjustment, possibly accompanied by penalties and, later, an interest fee or even double taxation.

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2 Ibid
viii) The weak and unfinished guidelines of the OECD mean a greater burden and higher cost for the petroleum industry than is necessary.

It is surprising and disappointing that the OECD did not make more an effort to clarify the attribution issue for the petroleum industry, which, due to its complexity, needs more specific guidelines than is currently the situation.

3. Attribution of income and expenses

The petroleum industry faces significant challenges with permanent establishment (PE) or subsidiaries abroad, as the income and expenses have to be allocated in a particular way and in accordance with Articles 7 and 9 in the tax treaties. In 2010 OECD published the Attribution Report, in which they established general guidelines for attribution of income and expenses, and now we are faced with generalized guidelines that are not quite applicable for the oil and gas companies.

The OECD’s members have decided to adopt the ‘functionally separate entity approach’ as the authorized OECD approach or preferred interpretation of Article 7 and, in order to hypothesise the permanent establishment or a subsidiary as a separate and independent enterprise, the following actions are required for each subsidiary or permanent establishment:

   a) a functional and factual analysis must be completed;
   b) attribution of income-generated assets must be stipulated;
   c) any risk created by the permanent establishment or a subsidiary must be attributed;
   d) attribution of necessary ‘free’ capital must be estimated;
   e) recognition of dealings between the permanent establishment or a subsidiary and the rest of the enterprise must be identified.

The authorized OECD approach is that the profits attributed to the permanent establishment or the subsidiary are the profits that the permanent establishment or subsidiary would have earned using the arm’s length price, in particular, in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions.

The attribution of income-generated assets, attribution of risk and attribution of necessary ‘free’ capital are extremely complex in the petroleum industry and need clarification beyond the guidelines that the OECD established in their Attribution Report. The following example of a cross-border pipeline demonstrates the weakness of OECD’s authorized approach:

The pipeline crosses four countries. The first country has the most technical equipment, such as the pumping station, remote control, the terminal and other technical equipment, which is necessary for the transport of the oil or gas in all countries. The second country does not have any employees at all. The third country could carry a higher risk than normal due to operating

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3 Ibid., Part 1, page 12
4 Ibid. Part 1 pages 14-20
the pipeline in the extreme cold or with challenging weather conditions, risk of leakage or political risk. In the fourth country it might be extremely expensive to build and maintain the pipeline if it is constructed through a mountain or in deep sea. The lengths and the capacity of the pipeline might differ; the building and maintenance costs might differ; and the periods of time the pipeline lasts might differ.

With such complexity it is a challenge for a petroleum company to attribute correct income and expenses between the different countries, making it very easy for the tax authorities to challenge the companies’ attribution as the OECD’s guidelines are not in line with the petroleum industry’s need for clarification.

4. Challenges

When multinational corporations operate cross-border, they need to attribute income and expenses in accordance with article 7 and 9 in the tax treaties and in line with the OECD Transfer Pricing Guidelines, as well as with the OECD’s authorized approach. Even if corporations make significant efforts to establish the arm’s length price, it is easy for tax authorities to challenge the Transfer Pricing price, routines, policies, documentation, etc. There is uncertainty, therefore, and high risk related to Transfer Pricing for the petroleum industry. In particular, there are uncertainties and a significant tax risk when the petroleum industry needs to measure risk, value assets and determine ‘free’ capital, as it is unclear how the petroleum business should apply and implement these general guidelines. In particular, the petroleum industry faces the following challenges and uncertainties:

i) measure the risk in each country

According to *the Attribution Report* paragraph 108:

“...in attributing profits to the PE (or subsidiary) the authorized approach uses a function and factual analysis to attribute...risks to the PE...It follows that under the authorized OECD approach it is necessary to attribute ‘free’ capital to the PE in accordance with the risks...so attributed.”

The challenge for the petroleum industry is to measure or estimate such risks in each country in order to attribute and evaluate the risks between the different countries. Different risks might be relevant in each country, such as entrepreneurial risk, health and safety risks, environmental risks, risk of leakage or blowout, tax risk, risk of sabotage, etc.

How should all these risks be evaluated and calculated for each country? In the example above there were four countries with different risk profiles and risk is even more variable in real life. Is it possible to evaluate all such risks for a pipeline and to be able to consider the risks separately for each country? Let us take the Deepwater Horizon oil spill / blowout in Mexico in 2010 as another example. It is the worst environmental disaster the US has faced and the financial consequences are uncertain. It could take several decades before the financial consequences from BP’s blowout are resolved. This demonstrates clearly that it is impossible to calculate such risks. *The Attribution Report* further states:

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5 Stage 1 – measuring the risk and valuing the assets attributed to the PE, page 35

6 BBC News US & Canada 30 May 2010
“However such risks may be more significant in some non-financial businesses, and where this is the case it would be appropriate to recognize that more ‘free’ capital would need to be attributed to support this entrepreneurial risk.”

According to the OECD authorized approach, petroleum companies are required to estimate the value of such risks for each country and attribute the cost of such stipulated risk to each separate country. It seems easy in theory, but it is near to impossible in practice.

The next challenge for the petroleum sector is:

   ii) value the assets attributed to each country

*The Attribution Report* states:

> “In applying Article 7(2), the facts and circumstances must, in the first instance, be examined in order to determine the extent to which the assets (tangible or intangible) of the enterprise are economically owned by and / or used in the functions performed by the PE.”

It is similar for attribution of income and expenses to a subsidiary.

The oil or gas company must establish a ‘tax balance sheet’ for each permanent establishment or subsidiary and estimate how each single asset is used and its benefit in each country. It is not only necessary to establish how the pumping station, the terminal and all other fixed assets are used in each country, but the pipeline itself in one country is of use to the other countries during transportation, so even the value of the pipeline should be attributed to the other countries. In such cases the permanent establishment or subsidiary is, for example, entitled to depreciation. Even worse, it is also necessary to investigate and estimate how the Group’s intangible assets have been used and benefited in each country. It seems simple in theory, but again, it is an impossible task in real life without specific and detailed guidelines. Whatever the oil or gas company put in as resources to establish the attribution, it can easily be challenged by the tax authority in more than one country due to inadequate guidelines.

Last but not least, the challenge for the petroleum sector is to:

   iii) determine the ‘free’ capital needed to fund the assets and support the risks in each country.

It follows from *the Attribution Report*:

> “Under the authorized OECD approach, the PE needs for tax purpose to have attributed to it an arm’s length amount of ‘free’ capital, irrespective of whether any such capital is formally allotted to the PE.”

Further the report states:

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7 OECD, 2010 Report on the Attribution of Profits to Permanent Establishment, D-2. First step: determining the activities and conditions of the hypothesised separate and independent enterprise, paragraph 72, page 28
8 OECD, 2010 Report on the Attribution of Profits to Permanent Establishment, (B) Stage 2 – determining the ‘free’ capital needed to fund the assets and support the risk attributed to the PE, paragraph 116, page 37
9 Ibid paragraph 117
“The next issue is how to attribute an appropriate amount of ‘free’ capital and interest-bearing debt to the various parts of the enterprise. The attribution would be made in accordance with where the assets and the associated risks have been attributed and should take into account, as far as practicable, the specific functions, assets and risks of the PE relative to the functions, assets and risks of the enterprise as a whole.”

After considering the functions, the assets and all the risks related to a permanent establishment or a subsidiary, the company must then calculate the necessary ‘free’ capital or equity, the permanent establishment (or subsidiary) needs for all the functions performed, for all the assets that might be used jointly, and all the relevant risks. There is no simple answer as to what is necessary ‘free’ capital and it is impossible to calculate the necessary capital. It is little more than a guessing game - just pick an amount out of the blue and hope that the tax authority will accept it. The amount you chose might be as correct as any other amount.

Allocating income and expenses is very time consuming and burdensome and, even if the corporations make significant efforts with this, there will still be uncertainty and risk as to whether the tax authority in each country will approve the calculation or challenge the corporation.

5. Solution

The OECD has recognized that there is a need for specific guidelines for banks and enterprises involved in the global trading of financial instruments, but they are yet to recognize the needs for the petroleum industry, even though the attribution of income in this industry is of greater complexity. Therefore, the OECD should establish more detailed guidelines, which provide practical examples for the attribution of income. This would result in:

- Less burdensome calculations for the petroleum sector.

- Less uncertainty for both the petroleum industry and the tax authorities.

- Less risk of transfer pricing adjustments, penalties, fees and even double taxation. Some large corporations carry a huge transfer pricing risk and some have even been forced to pay billions of USD in transfer pricing disputes\(^\text{10}\), and clarification on this topic with more specific guidelines for the petroleum industry would be beneficial.

6. Conclusion

The OECD’s Member States approved the Attribution Report in 2010, in which they also approved the authorized OECD approach for attribution of expenses and income for a permanent establishment or subsidiary. This approach is highly relevant for multinational corporations establishing subsidiaries abroad. The Attribution Report established general guidelines applicable to all businesses. However, the petroleum business is unique and faces challenges that do not affect other businesses when measuring risks, evaluating assets attributed to each country,

\(^{10}\) See for example the GlaxoSmithKline transfer pricing settlement, where were the company had to pay USD 3.4 billion in tax, and a claim to seek a refund for overpaid tax amounting to USD 1.8 billion was abandoned.
and determining the ‘free’ capital needed to fund assets and support risks. As the OECD recently approved and implemented the authorized approach for attribution of expenses and income, it is unlikely that they will make any progress or changes to this situation in the next decade. The petroleum sector could suffer in many ways because of the OECD’s generic guidelines, creating uncertainty, challenges, expenses and risks that probably no other businesses will face. Unfortunately, the OECD’s way of working could lead to yet another 10 years of difficulties, but hopefully they will recognize these weaknesses and uncertainty and eventually start the process of improving the guidelines. In the meantime, the petroleum industry will have to work with the existing and unfinished approaches.