

# ***BEPS Action Plans 8-10 and the oil and gas industry***



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The base erosion and profit shifting (BEPS) Actions 8-10 final report (the BEPS Report), published by The Organisation for Economic Cooperation and Development (OECD) in October 2015 aims to align transfer pricing (TP) outcomes with value creation.<sup>1</sup> A goal of the BEPS Report was to clarify guidance on and strengthen the arm's length principle, and where TP risks remained, to depart from the arm's length principle via "special measures." Specifically, the BEPS Report looks to end "misapplication" of the arm's length principle in the areas of intangibles, risk and capital, and other high risk transactions. This creates new challenges for exploration and production (E&P), oilfield service (OFS), and offshore oil & gas (O&G) companies in their treatment of capital, risk, and people functions, some of which we outline below.<sup>2</sup>

### **Risk, capital, and value creation in the context of BEPS**

A key theme in the BEPS Report is the interplay between contractual allocations of risk, financial capacity to bear risk, and exercise of control over such risk (i.e., related substance of the associated enterprise). In examining contracts, the BEPS Report emphasises the risk bearing entity's capacity to perform risk management decision-making functions as well as actual performance of those functions. This is a consistent theme in the BEPS Report, which generally covers the importance of capital, risk, people functions, and intangibles, but tends to focus more on people functions. Together with other BEPS initiatives that focus on overall headcount rather than relative contributions of those people to business success or failure, there is increased risk

that tax authorities may misunderstand capital intensive industries like O&G, conflate bodies on the ground with relative contributions to the group as a whole, and attempt to implement something that looks more like formulary apportionment than the arm's length principle.

In a post-BEPS world, E&P, OFS, and offshore O&G companies should look to review their structures paying specific attention to the location of decision-making activities, the location of financial capacity to bear risks, the multinational company's (MNC) position on its intangibles (if any), and how such factors map to the allocation of revenue, costs, and/or profits. This is particularly relevant as the BEPS Report emphasises substance over (legal or contractual) form and provides several specific examples where a tax authority's re-characterisation of a given transaction may be warranted. Whereas the pre-BEPS world placed more of an emphasis on limiting tax-related distortions on business operations, the post-BEPS changes may actually warrant that MNCs re-examine their operations to see whether and how changes in taxation may warrant real operational change.

### **General challenges for O&G BEPS and capital-rich, low function entities**

Historically, ownership of MNC assets has been typically viewed to accrue to those capital-rich entities which have provided the funding under an implicit "if you pay for it, you own it" doctrine. The BEPS Report challenges this historic view and places more emphasis on "the level of activity undertaken by the funding company." Particularly, where a tax authority should view a capital-rich entity as not exercising sufficient control or capacity to assume contractually assumed risks, the BEPS Report recommends that such returns associated with the risks be re-allocated elsewhere and the entities providing the funding be provided *no more than a risk-free return* on the funding provided.

The examples in the BEPS Report of the capital-rich, low function entities focus on intercompany financing, and place a specific emphasis on headcount and people functions. Nonetheless, MNCs in asset heavy industries (financial assets, physical assets, or otherwise) like O&G may expect to see tax authorities place more emphasis

- 1 On 5 October 2015, the OECD published a package of 13 final reports covering the 15 Actions of the OECD/G20 BEPS Project with a goal of promoting comprehensive, coherent, and coordinated reform of international tax rules.
- 2 Offshore support vessels (OSVs), floating production storage and offloading vessels (FPSOs), seismic companies, jack-ups, semisubmersibles, ROV assets, drillships, and others. E&P can mean independent E&P companies, or fully integrated E&P companies including National Oil Companies (NOCs) and International Oil Companies (IOCs). In some cases, we also only describe the downstream side of a fully-integrated E&P company, i.e., lubricant or petrochemical production and distribution.

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on people functions in spite of the economic reality that capital and returns to capital often play a more critical role in business success or failure.

### Operational asymmetries in the post-BEPS world

The BEPS Report emphasises a holistic approach to understanding TP and together with the group-wide reporting requirements of BEPS Action 13 could be interpreted to imply that differences in cross-country profitability of MNC group members with similar functional profiles relates purely to the shifting of profits. This can be particularly challenging for O&G/E&P companies where differences in production sharing agreement (PSA) regimes may place restrictions on the eventual pricing of production and will often cap (or disallow) deductions for interest, technical services (i.e., centralised/shared geoscientists or geophysicists), or procurement (capital expenditure, CAPEX) charges, thereby creating large differences in profitability among otherwise equal companies. Fully integrated E&P companies also often rely on index-based pricing (MOPS, ICIS, etc.) for transfer pricing in their downstream businesses which can lead to large differences in profitability across countries or time periods for similar activities. Although these types of differences are often a normal part of operations for O&G/

E&P companies, tax authorities may fail to consider all of the facts and circumstances and incorrectly conclude that any inconsistencies in financial performance are the result of profit shifting. Overall, these BEPS-related changes and the associated risks may lead O&G/E&P companies to re-examine their TP transactional models and structures or to reconsider their TP documentation and supporting defence files.

### Timing mismatches in the exploration, development and production cycle

There can be considerable time between exploration (pre-capture) and actual production and many such exploration costs are often incurred prior to a legal entity being established. During the 90 percent plus of the time when exploration is unsuccessful, the parent or affiliated entity cannot recover those pre-work costs. Going forward, E&P companies may want to consider whether and how to allocate such costs throughout the broader group, including what portion of such costs should be considered “shareholder” versus rechargeable costs and where not deemed as shareholder costs, establishing group-wide protocols to capture and bear such costs as well as the upside of successful production.<sup>3</sup> The decision to allocate or not allocate these costs throughout the wider group is particularly sensitive given the BEPS Report’s emphasis on corporate services as a “tool to shift profits.”



### Headcount and people functions in the post-BEPS world

Technology intangibles in addition to tangible sets can play a large role in operations of OFS companies. The BEPS Report places particular emphasis on profit shifting via the use of intangibles and is critical of relying on legal ownership as a means to allocate profits. The BEPS Report instead indicates that intangible-related profits should accrue to those entities that development, enhancement, maintenance, protection, and exploitation of intangibles (i.e., entities performing (DEMPE) functions). As a result, companies having centralised intangible owning entities or making use of royalties may want

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<sup>3</sup> All of which can be further complicated by PSA regimes.

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to re-examine their group's operations, paying special attention to DEMPE-related economic substance considerations and ensuring key decision making functions are aligned with intangible asset owners.

As another example, commodity trading can play a significant role in a fully-integrated E&P company's business model with respect to its ability to hedge risk and manage group capacity related issues. Due to the scale and frequency of these transactions, even small margins can generate substantial profits for a full-risk commodity trading company with limited personnel. Given the BEPS Report's perceived emphasis on people functions, companies with significant commodity trading operations may anticipate additional challenges. These challenges can either be in the jurisdiction itself or in other jurisdictions with relatively more headcount and lower profit margins due to tax authorities' misunderstanding of the business model.

The role of scale and people functions can have an impact on tax risk for petrochemical companies, as well. Dealing in commodity chemicals, regional sales and marketing entities within lean organisations like petrochemical MNCs may generate sales in very large quantities with just a few sales people, either based directly

in the country or based at regional hubs. The BEPS Report, taken together with BEPS Actions 7 and 13, can lead tax authorities to challenge this particular model, particularly when seeing very high top-line revenues, very low people count, and relatively modest in-country profit margins. As a result, in the post-BEPS world, petrochemical companies may want to pay special attention to their TP transactional models to thoroughly document where key decisions take place and any intangible assets within their group so as to reduce future TP and permanent establishment challenges from tax authorities.

### **Challenges for offshore O&G companies**

Key contractual arrangements such as bareboat charter arrangements (BBC), wherein a capital intensive, asset owner leases the asset to a contracting party that provides services to a third-party, can be expected to face additional scrutiny due to several items addressed in the BEPS Report.

### **De-emphasising the importance of contracts**

A general theme repeated throughout the BEPS Report is that the arm's length principle has been interpreted to over emphasise contractual allocations of functions, assets, and risks and that over



emphasis on contractual terms has led to manipulation and profit shifting. As a result, contractual relationships like BBCs can be expected to face a new level of scrutiny. Tax authorities may increasingly use their own views on functions, assets, and risks to challenge specific provisions in intercompany agreements or to re-characterise the transaction entirely. Specifically, the BEPS Report recommends re-characterising the terms of the transaction with respect to allocations of risk "which may not correspond with the activities actually carried out" in favour of entities exercising control or having capacity to bear those risks.

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### Requirement to understand the conduct of all parties to the transaction and potential comparable transactions within the MNC

The BEPS Report places a requirement on tax authorities to carefully delineate the actual transaction through understanding both contractual terms and conduct of all parties contributing value to the transaction. Specifically, tax authorities that have historically been content to understand only what is happening (functions performed, risks assumed, assets employed) within their specific jurisdiction are beginning to look outside their borders with more detailed information requests and full functional analyses on all direct and indirect parties to the transaction. Moreover, tax authorities which may not have made comparisons across similar transactions within the group are beginning to look at a particular transaction within the context of the MNC group as a whole.

Going forward, this may put stress on one-sided tests such as the comparable profits method/ transactional net margin method. This is particularly pertinent with respect to BBCs where the BEPS Report may recommend looking to people functions as being responsible for residual profits/ losses with less importance on the asset (i.e., capital and risk) to explain those same

residual profits/losses. A future outcome may be a residual profit split (value chain analysis) between lessor entities and other key entities within the group responsible for commercial and decision-making functions (CAPEX decisions, fleet location, etc.).

### **Transfer pricing in a downturn**

In the current economic downturn impacting the O&G industry, there is a likelihood of creating “phantom income,” that is, limited risk operating companies receiving income in various jurisdictions while the overall group experiences a system loss. This imposes a tax burden on the limited risk operating companies in MNC groups that is not borne by similar independent companies that are free to make losses and create tax assets during an industry-wide recession. During a short-lived downturn, this implied restriction on limited risk operating companies within MNC groups to be profitable may even be consistent with their risk profile.

In periods of prolonged downturn, however, it may be appropriate to recognise that independent third-parties, operating at arm’s length, will consider their available alternatives and elect to renegotiate contracts when the contract terms are no longer consistent with economic and operational reality. In the same way that an independent entrepreneur or asset owner would not be perpetually bound to fulfil a

contract resulting in continuous losses, and an independent operating company would not insist on enforcing contract terms that drive a valuable business partner into bankruptcy, it may be reasonable for O&G companies to re-examine their own TP policies and intercompany agreements in light of economic reality.

### **Conclusion**

The OECD’s BEPS Report aims to align TP outcomes with value creation through a focus on capital, risk, people functions, and intangibles, but arguably puts more weight on people functions. Although the BEPS Report aims to strengthen the arm’s length principle and better match taxable income with economic reality, this apparent over emphasis on people functions and de-emphasis of contractual allocations of risk may produce challenges for industries where capital and risk play a larger role than headcount in creating value. In this post-BEPS world, O&G companies may want to consider re-examining their TP transactional models and operations to see if a re-aligned TP model is necessary.

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