Leading practices for managing double taxation risk in the oil and gas industry

Double jeopardy…

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Industry expansion leading to greater costs

The significant expansion of oil and gas (O&G) companies globally makes the need for industry players to align and coordinate local operations with corporate strategy greater than ever. As a result, the majority of multinational energy companies incur significant general and administrative expenses related to headquarters services rendered on behalf of foreign affiliates. In addition to general management and administrative activities including accounting, human resources (HR), and information technology (IT) services, O&G companies may also charge their related parties for centralised quality, health, safety, and environmental (QHSE) support services, engineering and technical services, and procurement and logistics services – among other functions – performed by corporate departments.

Global oil and gas expansion increases need for industry player alignment

The OECD Guidelines provide for – and many countries, including the United States, require under their local transfer pricing rules – charges for intercompany services that provide or are intended to provide a benefit to related parties. Although specific rules in a jurisdiction may allow for certain expenses to be allocated at cost, in some cases the services are required to be charged with a mark-up.

Tax authorities' response to OECD charges

Many tax authorities are sceptical of these charges – particularly those including a mark-up – and impose local requirements mandating documentation showing the direct benefit received by the local affiliate or disallow the deduction of the service fee for tax purposes at the local level completely. In many cases, these decisions are made by the foreign tax authority unilaterally, not considering that there may be potential implications under an existing income tax treaty.

When this situation arises, a company potentially could be required to pay tax twice on the same income for the same period – in the local country which disallows the deduction and in the host country where the counterparty to the transaction must report the income on its tax return and pay tax on that income.

It is critical that corporate finance personnel recognise that a disallowance of an otherwise appropriate expense allocation or charge has potentially far-reaching tax consequences and take action to remedy the situation.

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Certain disallowances can have significant tax consequences

Many of the developing countries in which multinational O&G companies operate do not have extensive treaty networks. As such, remedies such as Competent Authority may not be available.

Intercompany headquarters services

To capitalise on economies of scale and remain cost competitive in the global marketplace, O&G companies generally centralise administrative, management, and back office services. These shared services may be executed through the parent company's headquarters or in one or more regional service centres.

In addition to strategic management and corporate goal setting, the services provided at the head office level may include but are not limited to:

- Sales and marketing, including brand development and management
- Accounting, finance, and treasury administration, including global cash management
- Tax planning, reporting, compliance, and controversy support
- Legal and general counsel functions
- Management information systems and IT

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- HR, including expatriate personnel management, payroll, and benefits administration
- Engineering and technical support services
- QHSE programme development and management
- Corporate structuring and planning, including merger, divestiture and acquisition planning and execution
- Purchasing, logistics, and procurement, including asset and materials management
- Stakeholder relations, including investor, public and media relations
- Intellectual property administration, including patent and trademark registrations and defence

Broadly, headquarters activities can be bifurcated between those activities that provide a benefit to related parties and those that are performed on behalf of the company performing the activity. As a threshold matter, headquarters services must not duplicate the activities performed at the local level and be seen as providing a recognisable benefit to the recipient in order for a charge to be made in most jurisdictions.

Services providing indirect benefits to more than one member often most contentious

Services providing indirect benefits to more than one member of a controlled group – such as QHSE programmes and company-wide asset management activities – are often the most contentious as local tax authorities are typically reluctant to accept charges for activities which do not appear to have a direct impact on the recipient.

Issues raised by foreign tax authorities

Due to their heightened visibility, O&G companies are on the radar of tax authorities around the world. Increasingly, multinational enterprises are facing tax authorities in many jurisdictions – including member states of the OECD – taking aggressive positions on audit to disallow the deduction of allocated headquarters services charges. In the case of more sophisticated tax authorities, the disallowance may be explained in a well-reasoned manner. Conversely, in less advanced economies, no justification may be offered at all.

Historically, foreign tax authorities have challenged headquarters services charges on the basis of lack of direct benefit received in the local country, misallocation of charges between affiliates, and inappropriate mark-up applied. Absent planning and proper documentation that meets local

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country requirements, these disputes can be difficult to address in the foreign jurisdiction. If these issues are raised in a treaty country, then relief may be available through Competent Authority under the Mutual Agreement Procedure (MAP) of the treaty.

Disallowance: Tax authorities see some troubling trends

However, a troubling trend has emerged over the last several years. Some tax authorities have asserted that the disallowance of the deductibility of headquarters services charges is a domestic issue – tied to local rules – and insist that Competent Authority has no right to negotiate the issues. For example, Mexico has been observed to deny inbound expense deductions claiming domestic substantiation and form requirements are not met. Invoicing and cash settlement is another common reason given for disallowance of headquarters services charges, particularly in CIS countries. These jurisdictions do not accept offsetting journal entries or accounting cross charges, instead demanding that intercompany invoices be rendered and payments be made in cash.

Specific challenges for O&G companies

Due to the contractual nature of deals in the O&G space, there are particular issues industry participants face in determining and charging appropriately for headquarters and other management services.

Whether for commercial, liability, or other reasons – such as local content laws – O&G companies often will enter into a joint venture (JV) relationship with one company as the operator and others as investors who pay the costs of the operation. While seemingly a third party relationship, a JV could face a near "perfect storm" where investors in the JV refuse to accept mark-ups on the operator's service charges – seemingly an example of third party negotiations – while a tax authority asserts a mark-up on a perceived related party transaction.

Critical matter: Oil and gas companies need holistic approach to structuring joint venture activities

It is critical that O&G companies take a holistic approach to structuring their JV activities taking into account the tax implications of service activities performed by one or more members of the JV and prepare the appropriate analysis and documentation to support their positions.

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Leading practices

While the challenges related to foreign deductibility of headquarters services charges allocated by multinational enterprises will likely continue, corporate personnel can take proactive steps to better defend these deductions. Companies should consider taking the following actions:

What are the proactive steps corporations can take to defend deductions?

- **Put in place** comprehensive intercompany agreements and ensure that the duly executed agreements are registered with the appropriate local authority, where applicable.
- **Ensure** that intercompany charges are supported by specific invoices designed to meet local requirements for invoicing and payment.
- **Understand and follow** local transfer pricing documentation requirements.
- **Develop and maintain** specific evidence substantiating the benefits received by the local entities from the head office, where possible. This documentation could include executive travel logs, meeting notices, training or operating manuals, and the like, evidencing that important directions and guidance are communicated to the local entity from the corporate headquarters.
- **Identify and retain** local advisors to give timely direction on tangential sourcing issues for withholding purposes and indirect tax consequences.

When Competent Authority is not available, advisors with experience and a physical presence in the foreign jurisdiction are even more critical. This local presence is imperative as court actions, bond applications, and other necessary events and processes have deadlines and procedures unique to each country. The ability to navigate these local requirements is vital to achieving a successful outcome for the company.

Ultimately, advance planning and documentation prepared in accordance with the relevant jurisdictional requirements is essential to multinational O&G companies successfully defending headquarters services charges in both domestic and foreign environments.

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