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Avoiding double taxation in the oil and gas industry

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Given the significant expansion of oil and gas companies globally, the need for industry players to align and coordinate local operations with corporate strategy has never been greater.

As a result, the majority of US-based 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, and information technology services, oil and gas companies may also charge their related parties for centralized quality, health, safety, and environmental (QHSE) support services, engineering and technical services, and procurement and logistics services—among other functions—performed by corporate departments.

The US Treasury Regulations require charges for intercompany services that provide—or are intended to provide—a benefit to related parties. Although the specific US rules governing the provision of services between related parties allow for many of these expenses to be charged at cost, in some cases the services are required to be charged with a mark up.

Many tax authorities outside of the United States are skeptical 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 with the United States.

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 United States 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 recognize that a disallowance of an otherwise appropriate expense allocation or charge—in a country with which the United States has a tax treaty—is a direct violation of the treaty and take action to remedy the situation.

Many of the developing countries in which US oil and gas companies operate do not have tax treaties with the United States. With respect to these non-treaty jurisdictions, US companies should note that all reasonable and effective measures to reduce the local tax liability must also be exhausted before a payment is made, otherwise the payment may be deemed voluntary under US rules. Voluntary payments cannot be applied as credits for foreign taxes paid against a company's US Federal income tax liabilities also resulting in the potential for double taxation.

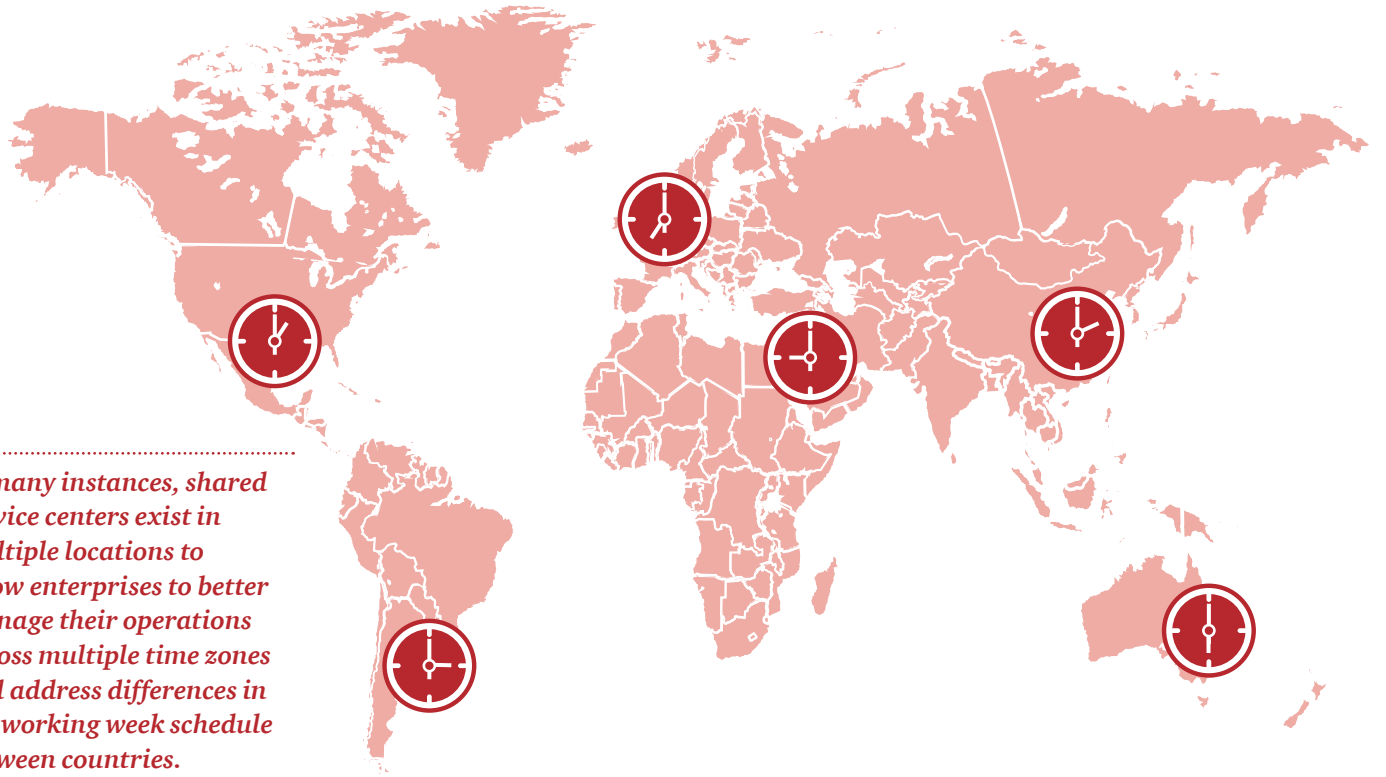
Intercompany Headquarters Services. To capitalize on economies of scale and remain cost competitive in the global marketplace, oil and gas companies generally centralize administrative, management, and back office services. These shared services may be executed through the parent company's US headquarters or in one or more regional service centers. In many instances, shared service centers exist in multiple locations to allow enterprises to better manage their operations across multiple time zones and address differences in the working week schedule between countries. For example, in many Middle Eastern jurisdictions the working week runs from Sunday through Thursday as opposed to Monday through Friday.

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 technology
- Human resources, including expatriate personnel management, payroll, and benefits administration
- Engineering and technical support services
- QHSE program 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 defense

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 recognizable benefit to the recipient in order for a charge to be made.

Services providing indirect benefits to more than one member of a controlled group—such as QHSE programs 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.



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In the oil and gas industry, services which are generally not considered value-added may in fact, in the words of the regulations, "contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group" and therefore may require a mark up.

US Rules Governing Intercompany Services. Broadly speaking, most headquarters services are not considered to be value-added under US rules and are eligible to be charged at cost. In the oil and gas industry, however, services which are generally not considered value-added may in fact, in the words of the regulations, "contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group" and therefore may require a mark up. For example, a QHSE function that is generally considered to be non-value adding for most companies may actually be a core capability of an oil and gas company that competes on the basis of its safety and environmental protection record.

Issues Raised by Foreign Tax Authorities. Due to their heightened visibility, oil and gas companies are on the radar of many tax authorities around the world. Increasingly, US-based multinational enterprises are facing tax authorities in foreign jurisdictions—including member states of the Organisation for Economic Co-operation and Development (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 country requirements, these disputes can be difficult to address in the foreign jurisdiction. If these issues are raised in a country with which the US has a tax treaty (commonly called treaty countries), then relief may be available under Articles 7, 9, or 24 (Discrimination) and would require a filing with the US Competent Authority under the Mutual Agreement Procedure (MAP) of the treaty.

However, a troubling trend has emerged over the last several years. Foreign tax authorities in treaty countries have asserted that the disallowance of the deductibility of headquarters services charges is a domestic issue—tied to local rules—and insist that the US Competent Authority has no right to negotiate the issues. Tax authorities in evolving treaty countries—such as Mexico—have consistently denied 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 Oil and Gas Companies. Due to the contractual nature of deals in the oil and gas 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—oil and gas 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, US transfer pricing rules focus on effective control—in other words, economic command of the transactions regardless of ownership percentage. In these situations, a JV could face a near "perfect storm" where investors in the JV refuse to accept markups on the US operator's service charges—seemingly an example of third party negotiations—while the US Internal Revenue Service (IRS) asserts a markup on a perceived related party transaction.

It is critical that oil and gas 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.

Dispute Resolution in Treaty Countries. If allocated headquarters services charges are disallowed in a treaty country, then the US foreign tax credit (FTC) regulations governing the ability of US taxpayers to claim dollar-for-dollar credits against their US Federal income tax liabilities based on foreign taxes paid must be carefully considered.

The IRS continues to challenge FTCs resulting from foreign tax assessments when the taxpayer has not exhausted all remedies before remitting payment. It is the position of the IRS that the foreign tax is not compulsory, and therefore a FTC cannot be claimed.

US rules establish that a foreign levy will be considered an "income" tax if, and only if, it is a tax and the predominant character is that of an income tax in the US sense. A foreign levy is considered a tax if it is a "compulsory payment pursuant to the authority of the foreign county to levy taxes" under US rules. The determination as to whether a levy is "compulsory" is to be determined by US principles of law, not the laws of a foreign country. Under US rules, to the extent that the amount paid exceeds the amount of liability under foreign tax law, the surplus imbursement is not compulsory and, therefore, not considered as foreign tax remitted.

Most importantly, the US rules obligate the taxpayer to attempt to decrease the foreign tax liability over time and to exhaust all "effective and practical" remedies, including Competent Authority, to reduce such foreign tax liability. The term "Competent Authority" is used in income tax treaties to identify the designee or representative in each of the jurisdictions who will be responsible for implementing the treaty and its provisions.

In order to claim a FTC on a disallowed amount that falls under one of the treaty articles, and to ensure that correlative relief is allowed under IRS audit, Competent Authority consultation and usually a Request for Competent Authority Assistance are required. Any efforts to "self remedy" a disallowance of a treaty expense can be disallowed on examination and IRS international examiners are instructed to review this issue.

Dispute Resolution in Non-Treaty Countries. Many of the same controversies also exist in non-treaty countries. Although the same FTC considerations apply, in the absence of a treaty there is no Competent Authority to intervene when mutual agreement cannot be reached between the taxpayer and the local tax authority. When Competent Authority is not available, corporate personnel may best be advised to retain the services of advisors with experience and a physical presence in the foreign jurisdiction. This local presence is critical 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.

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

- 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.
- 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.
- Retain local advisors to give timely direction on tangential sourcing issues for withholding purposes and indirect tax consequences.

Ultimately, advance planning and documentation prepared in accordance with both US and local jurisdiction requirements is essential to US-based oil and gas companies successfully defending headquarters services charges in both domestic and foreign environments.

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