Question 1

Part 1

Transfer Pricing (“TP”) is a key issue for oil & gas companies (“IOCs”) operating internationally when planning their tax affairs. The ultimate goal of an IOC is to reduce the profit in the country (or countries) with high tax rates and generate most of the profit in countries with lower tax rates. The scope is very broad relating to the pricing of:

a) Intragroup services such as head office costs or administrative services (accounting, finance, HR, IT, legal, etc.)

   Companies might establish group service centres providing these admin services. As in all cases, these services should be typically charged at arm’s length and direct method is applicable. Companies are usually trying to overcharge these activities by having a higher than usual (non-arm’s length) mark up, however, since these are standard services, comparables are easy to source. In situations where the value of services is difficult to estimate, the indirect method can be used.

   It is important that there should be no duplication of services.

b) Technical services (a type of intragroup services)

Subsidiaries providing technical service companies may be registered in a low-tax jurisdiction. Since these are usually services which are more difficult to value, since the economic or commercial value of the recipient of the service is higher, finding the appropriate TP method is a bit more challenging. However, the IOC also has more planning opportunities by potentially allocating more profit to the service provider.

c) Financing activities (interest rates on loans, guarantee fees)

IOCs may establish group treasury companies and in-house funding vehicles. This enables borrowing under larger-scale programmes on financial markets in order to achieve lower interest rates and reduce group funding costs.

Typically such entities are also based in low-tax jurisdictions and the question arises as to whether the interest rates or guarantee fees are charged at arm’s length, since IOCs will try to allocate higher margins in low-tax jurisdictions.

d) Royalties

   IOCs may establish a group IP company in a low-tax jurisdiction with a preferential tax regime for taxing royalties (eg Switzerland) or in the future with an IP Patent Box regime that would charge a royalty for the use of trademarks, customer contact lists or other proprietary IP.

   As part of the Base Erosion and Profit Shifting (BEPS) project there are various issues coming up for the valuation and use of IP. The newly suggested modified nexus approach for IP companies has to be factored in when setting up an IP company. Also the valuation of intangibles for TP purposes will be revisited and more source country taxation rights are expected to come.

Another option is to establish cost contribution arrangements or cost sharing agreements which allow related or unrelated parties to share certain costs incurred for a common purpose.

e) Group procurement activities

If there is a company purchasing goods and services and resells it to other related parties, the question is whether the re-sell price is at arm's length. Such group procurement entity is mostly based in a low-tax jurisdiction trying to maximize the profits generated.

f) Oil and gas sales between related parties – group trading companies

For as long as straightforward commodities are sold, there are not too many TP issues, since such commodities have published market prices. Significant issues may arise if different grades of oil and gas are sold or different delivery locations than the benchmark prices are involved. Countries might also impose a set sales price (see Aramco Case - 1996).

Part 2

Governments have various means to tackle TP issues and they mostly result in a so-called transfer pricing adjustment (upwards or downwards) and this also largely depends on what kind of tax regime applies in a given country, i.e. whether there are Profit Sharing Contracts, Service Contracts or a Concession regime, since contractual regimes may limit already the deductibility of certain costs or define at what rates they might be charged.

a) For sales of oil and gas between related parties, governments may specify and official sales price in a government license (including PSC). Some countries (e.g. Norway calculate tax based on official sale prices, although this might be a problem for oil and gas companies using forward sales and derived income less than the Norwegian official price to calculate the tax.

In the Texaco Denmark case, the Danish courts argued that spot prices should be used to have higher profits allocated to the Danish entity.

b) In group financing activities, governments will try to argue that many of the intragroup financing is implicit support (see The Queen vs. General Electric Capital Canada) and does not justify the even an arm's length fee or interest rates should be lower on intragroup loans.

Besides transfer pricing adjustments, governments may also apply statutory thin capitalisation rules if entities are overly debt financed.

c) Governments may also apply (upon request by the taxpayer) advance pricing arrangements (APA). This gives certainty to both, government and the taxpayer for certain tax positions.

d) Governments might also challenge the pricing of certain intangibles if various activities in connection to the intangible are performed in various jurisdictions (e.g. marketing, sales, research and development, etc.) In this context see the GlaxoSmithKline case where the IRS argued that the embedded marketing intangibles that were owned by the US taxpayer were more valuable than the research activities carried out by the UK entity, hence, a higher profit should be allocated to the US.

Question 2

Part 1

The key features of the regimes listed below are as follows:

Concessionary regime:

- This is an agreement between the government and a company based on a concession whereby the government grants the company the exclusive right to explore, develop, produce, transport and market the petroleum at its own risk and expense within a fixed area for a specific amount of time.
- The IOC is entitled to legal ownership of the production and can freely dispose over it, i.e. the government transfers title to oil and gas to the IOC.
- Usually, a concessionary regime involves a combination of corporate income tax, special petroleum (sometimes also referred to as hydrocarbon tax) and royalty. Many concessionary regimes do also impose bonuses (signatory and/or discovery and/or production bonus).
- Ring-fencing is also often applied, either oil and gas activities itself or individual projects. In other words, profits and losses may not be set off between projects or fields.
- Royalties and also bonuses may be applied on a sliding scale.

Profit Sharing Contracts (PSC) or Profit Sharing Arrangements (PSA)

- In a PSC regime the government retains title to oil and gas and gives a right to share production (profit oil) to the IOC.
- In a common PSC, a portion of total production is retained by the contractor to recover their costs as cost oil.
- State equity: Government may have an option to acquire interest in the oil and gas field at a certain price (market value, concessional amount or for no additional consideration).
- The deductibility of costs and expenses are defined (type of costs, limitations, capped costs) for calculating cost oil.
- PSCs often have stabilisation clauses in order to protect the IOC from future changes in laws and regulations.
- PSCs may include exemptions from certain taxes, e.g. VAT, import and customs duties.
- PSCs are limited in time (typically aligned to the lifecycle of an oil field, e.g. 35 years as in the case of Egypt).
- Local contractors, employees must be given preference, trained or generally invested in.

Service Contracts (SC)

- The government retains title in the oil and gas.
- In an SC the IOC acts as a contractor. The IOC might bear all the risks if the venture is unsuccessful (risk sharing contracts) or receive a fee for services performed irrespective of the outcome of the development.
- If the venture is successful, the IOC may recover costs and receive a fee that is defined in the service agreement, typically incrementally increasing if the oil price or production is changing.
- IOC also has to pay corporate income tax.
- The SC regime is often combined with royalties and bonuses.
- An SC is usually applied for shorter projects (e.g. 10 years or less).
- Local contractors, employees must be given preference, trained or generally invested in.

To sum up, the key difference between the various regimes are:

- Legal ownership (remains with the government in a PSC and Service Contract system).
- Acquiring of interest in the oil field - this is usually not possible in a concessionary regime.
- In an SC, the IOC is a contractor, whereby in a PSC the IOC is more of a long-term JV partner. In a concessionary regime, the IOC receives the net income after costs, tax and royalty. Under a PSC, the IOC gets cost recovery and a share of the remaining profit, whilst under an SC it receives the cost receivery and a profit fee or remuneration until handover date.

Part 2

In developed countries, the concessionary regime prevails (e.g. Norway, US, UK, Australia). Many developing countries believe that retaining ownership would allow them to control the oil and gas production and the earnings. However, ownership and control do not necessarily correlate. There is not guarantee that engaging an IOC on a contractual basis ensures full political control and accountability. However, many developing countries forbid foreign ownership of national resources, so there is a legal issue to it as well (e.g. Sharia law).

Even amongst the contractual regimes, there are substantial differences. SC are less suited to encourage oil and gas exploration and development as there is a much lower profit incentive. Iraq has the experience of having two different systems, whereby in the Kurdish area there was a PSC system in place and in other areas an SC based on the model oil field technical service contract. The latter was very successful for as long as the oil prices were very high, since the IOCs did not participate that extensively in the profits as they would have under a PSC. However, these contracts are currently under negotiation.

In an SC the contractor has no incentive to reduce long-term costs, since the field is likely to be under the control of the government. This can be considered as a major limitation of the SC because a long-term partnership with a contractor (e.g. PSC) may result in better overall field performance and much more value for the state than in the short-term approach. Under the SC the contractor does not benefit from any upside in reservoir or oil price, since it received a predetermined remuneration fee.

Even in a concessionary regime the governments have often the right to purchase a portion of production at a lower price than the market price.

Bonuses provide for a welcome windfall tax (so do royalties) to cover government expenses and provide for immediate revenue. The question is whether such expenses can be deducted by the IOC for income tax or hydrocarbon tax purposes or can be allocated to cost oil (which is usually not possible).

If there is no ringfencing, this can postpone government tax receipts, may discriminate against new entrants.

Question 4

Part 1

A warranty provided by the seller essentially promises that certain circumstances or facts apply, on other words, it is a contractual assurance provided by the seller. These warranties are obviously important for the buyer, since the buyer would like to be certain that there are no tax risks which must be calculated or, if necessary, included in the purchase price. The warranties also serve as a basis for potential litigation if any of them would turn out to be untrue and the seller has committed a breach of warranty. A party (mostly the seller) that breaches a warranty can only be held liable for loss and damage that is foreseeable as a result of the breach. Also, if the buyer has become aware of any tax issues during the due diligence, the seller might want to limit its responsibility.

This might include issues such as:

- All tax returns are filed - buyer has to ensure that there are no penalties or late payments and this is confirmed by the auditor's report.
- All taxes owed and due are paid - the issue is when is the cut-off date? Until what time is the seller responsible for paying taxes? Usually the parties agree that taxes that became due before the transaction is completed have to be borne by the seller.
- There are no encumbrances on any of the company assets that arose in connection with any failure to pay such tax.
- There are not ongoing tax audits which might lead to transfer pricing adjustments or late payments, penalties, etc.
- There is no ongoing tax litigation - the buyer would want to ensure to have the opportunity to intervene if this is the case (and possible as per the applicable procedural laws).
- There is no risk of multiple tax residencies that might trigger tax obligations in other jurisdictions (other than those known or disclosed to the buyer).
- There is currently no permanent establishment risk in any country of which the seller knows.
- The seller has not been notified of any failure of being non-compliant with any tax incentive programs applicable to the oil and gas industry in the country of oil operations.
- The seller is not party to a tax indemnity agreement. Such an obligation might be transferred to the buyer.

Part 3

An indemnity is a contract by which the party providing the indemnity as an original and independent obligation to indemnify a loss. It is somewhat mirroring the warranty clause as the seller will have to indemnify the buyer for those issues the seller provided a warranty for.

The most important tax is the capital gains tax that might arise following the successful completion of the transaction (depending on the tax laws of the jurisdiction where the asset is located) and which in most of the cases has to be paid by the Seller. In some jurisdictions (e.g. India – Vodafone case, indirect share transfer case), the capital gains tax will be imposed on the buyer of the asset, even if the seller is legally obliged to pay.

Other than that, the seller might also agree on indemnifying the buyer for any transfer taxes or other costs (reasonable legal fees in relation to existing tax disputes).

For both, the indemnity and the warranty, it is important that the buyer obtains them from a solvent counterparty having enough assets, which is in most cases the parent.

Question 7

It is certain advisable from a tax perspective to engage in a downstream merger in Brazil. This requires a Brazilian vehicle (BrazilCo) as suggested to acquire the target company (BrazilTarget). BrazilCo would be funded with debt by a foreign parent company for this transaction located in a jurisdiction which has a tax treaty with Brazil (e.g. the Netherlands). BrazilCo would then merge with BrazilTarget and transfer the debt to BrazilTraget, whereafter BrazilCo would be liquidated. This is insofar important, since Brazil does not have tax consolidation which would allow interest deductions in BrazilCo to be used to offset future profits in BrazilTarget. Following the downstream merger and the liquidation of BrazilCo the related debt moves to BrazilTarget and as such allows for interest deduction to be moved to BrazilTarget.

Risks:

- Thin capitalisation rules have to be considered. Under the current Brazilian rules, irrespective of whether the intercompany loans are compliant with the general rules governing the deduction of expenses and Brazilian TP rules, interest expenses are only deductible if the related Brazilian borrower (in the present case BrazilTarget) does not have a debt-to-equity ratio greater than 2:1. Any excess interest is not deductible for the purpose of Brazilian corporate income tax.

  Furthermore, if the funding company is based in a low-tax jurisdiction, the debt-to-equity ratio may not exceed 0.3:1. Currently, the Netherlands are not blacklisted, however, Switzerland and Luxembourg were both blacklisted by Brazil in the past despite being popular jurisdictions for international holding and financing companies, hence, this has to be observed as well.

- Brazil has numerous taxes on inbound and outbound payments, most of which cannot be reduced by tax treaties.

Structuring opportunities:

- This structure is even more favourable if BrazilTarget is any losses, in which case it has to be ensured that the company with the tax losses will survive the merger.
- Dividends can be paid without incurring any WHT to the parent company in the Netherlands (or any other jurisdiction with participation exemption).
- Having a Dutch parent company might be beneficial if there is a future sale of the subsidiary.

Once the acquiring company starts working, the following has to be considered:

- There should not be any transfer of IP rights into Brazil to avoid Brazilian exit tax (at a later stage). If this has to be done, then a local Brazilian entity could be established and IP rights transferred to that entity (BrazilNewCo) at cost and BrazilTarget would pay a royalty to BrazilNewCo also to avoid withholding taxes on cross-border payments of royalties. Otherwise, the involvement of a jurisdiction with a tax treaty having preferential WHT rates on royalties might be sought.

- If technical services have to be provided to BrazilTarget, the should also be done through a local entity to avoid WHT on cross-border payments as a remuneration for technical services.

- If the buyer wants to transfer crude oil to a trading company abroad, transfer pricing rules have to be taken into consideration. Brazil deviates from the OECD's arm's length principle. There are no profit-based methods and a functional analysis is not necessary. Profit margins are determined by law which might not be consistent with an arm's length result. Also, Brazilian TP laws have a very broad definition of "related parties".