

# CHARACTERISATION AND TAXATION OF CROSS-BORDER PIPELINES

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# PhD

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# AGENDA

- Contents
- Why this topic?
- Hierarchical ranking
- Characterisation in general
- Characterisation of pipelines
- Exploration
- Pipeline in a transit State
- Allocation of income
- Conclusion & recommendation

# CONTENTS OF PhD

- C 1 – Introduction
- C 2 – Characterisation
- C 3 – The Concept of int'l law and int'l tax law
- C 4 – Hierarchical ranking in int'l tax law
- C 5 – Characterisation of a cross-border pipeline as preparatory or auxiliary character, Immovable property, passive income or as other Income

# CONTENTS OF PhD – 2

- C 6 - Characterisation of cross-border pipelines as PE
- C 7 – Allocation of income for the different characterisations
- C 8 - Conclusion and recommendations

# WHY THIS TOPIC?

- OECD Model Tax Treaty and Commentaries are inconsistent
- No int'l common approach on characterisation
- Characterisation between PE and auxiliary or preparatory character
- No common approach on allocation of income
- Relation between int'l law & int'l tax law
- Hierarchical ranking
- IFA – No research found

# HIERARCHICAL RANKING

- Significant numbers of sources for pipelines: int'l treaties, int'l law, tax treaties, Commentaries, GATS, investment treaties (Energy Charter), Lisbon treaty, pipeline treaties, domestic law, pipeline contracts
- Important to establish hierarchical rank, but no clear rank
- Each case must be considered separately
- Sometimes conflict, overlapping or supporting each other

# CHARACTERISATION

- Well-known problem
- Occur because authorities interpret or apply tax treaty differently, use different methods or theories or characterise differently
- OECD model tax treaty self-contradiction & vague
- Double taxation or less than a single taxation might occur
- Significant difference in taxation
- Higher challenge for pipeline companies



# CHARACTERISATION PIPELINES

OECD: Eight different characterisations of pipelines:

- Construction PE (Art. 5.3)
- PE (Art 5.1)
- Transport facilities (Art. 5.4)
- Preparatory or auxiliary character (Art. 5.4)
- Combination (Art. 5.4)
- Immovable property (Art. 6)
- Passive income (Art 5.1)
- Other income (Art 21)

# CHARACTERISATION PIPELINES 2

- Not possible to generalize; each case must be considered separately based on fact, circumstances & relevant sources
- Pipeline as construction PE – normally no problem
- Pipeline as immovable property – why?  
Creates uncertainty
- Other income – most unlikely

# CHARACTERISATION PIPELINES <sup>3</sup>

Income from pipelines as passive income:

- Where tangible properties are let or lased to third parties – normally PE
- Where tangible properties are let or leased to third parties without maintaining or wider responsibilities like operating, service, inspection, the income might be considered as passive income

# CHARACTERISATION PIPELINES 4

Distinction between Art. 5(1) PE and preparatory or auxiliary character Art. 5(4)

- Starting point Art. 5(4)
- Art. 5(4) only when transportation of its own oil or gas. If transport for other as well, Art. 5(4) cannot be used
- Far from clear, but nevertheless important
- PE – source taxation
- Of preparatory or auxiliary character – resident taxation

# CHARACTERISATION PIPELINES 5

Need to consider:

- Is the activity remote from the general purpose of the business (preparatory or auxiliary character)? (Art 5.4)

Or is it

- an essential and significant part of the activity (PE) (Art 5.1)

# CHARACTERISATION PIPELINES 6

Conclusion PhD:

- A pipeline is normally too significant to be considered as of preparatory or auxiliary character / transport facility (Art. 5.4)
- Art. 5.4 will only apply in very rare situations

# CHARACTERISATION PIPELINES 7

Conclusion cont:

- Pipelines satisfy all tests in Art 5.1 (place of business test, location test, factual use test, permanence test, at disposal test etc)
- The German Pipeline case – PE
- The West African Pipeline project
- Offshore articles in tax treaties

# CHARACTERISATION PIPELINES 8

Conclusion cont:

- Pipeline compared with net electricity, railways and automatic equipment
- Energy Charter model pipeline agreements
- Different pipeline treaties
- Country practice
- Pipeline creates a PE in most situations



# EXPLORATION

## OECD Commentaries:

- Countries can characterise income from exploration just as they like.
- No recommendation or guidelines
- Conclusion PhD:
- Must be considered in case by case, but it will create a PE in most situations
- Several court cases: PE created

# PIPELINE IN A TRANSIT STATE

- Must be considered in case by case based on facts, circumstances & relevant sources
- Jurisdiction to tax offshore
- Limitation in tax treaties?
- Is the pipeline in the transit State a PE?
- OECD Commentaries:
- Transportation of own and third party's oil – a PE might be created

## PIPELINE IN A TRANSIT STATE <sup>2</sup>

Solely transportation of its own oil or gas:

- If the transporting is *merely incidental* to the business, it will be of preparatory or auxiliary character and taxed in the resident State.
- PhD: transportation of oil or gas for a oil company is almost always essential and significant part of the oil or gas company's activity and can only very rare be considered as *merely incidental*

# ALLOCATION OF INCOME

- Article 7 and OECD TP Guidelines
- No specific guidelines related to allocation of income in Model Tax Treaty or Commentaries for pipelines
- Allocation of income from pipeline extremely complex; (attribution of assets, risks, 'free' capital etc)
- Significant risk
- Some pipeline agreements more detailed

# CONCLUSION PhD

- Sources in int'l law and int'l tax law normally overlap and support each other rather than conflict
- No clear hierarchical rank among sources
- Pipelines should not be characterised as immovable property or other income
- Pipelines should very rarely be considered as of preparatory or auxiliary character
- Pipelines meet all tests for PEs
- Conflict resolution – according to several sources

# RECOMMENDATIONS

New articles in OECD Model Tax Treaty and in Commentaries:

- Tax treaty relationship to other treaties
- Commentaries legally binding or not
- Offshore articles
- Clear statement that pipelines normally create PE'

# RECOMMENDATIONS <sup>2</sup>

- Paragraph 26.1 in the Commentaries to Article 5.4 needs to be updated
- OECD should publish specific guidelines regarding allocation of income from cross-border pipelines



THANK YOU

QUESTIONS / COMMENTS?