

## AUDIT OF THE GAS, PETROLEUM AND OIL SECTORS

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*Presentation PPT*

### 1. AUDITING OF THE PETROLEUM SECTOR IN NORWAY

#### 1.1. The importance of the Petroleum sector in the Norwegian Economy

As many of you probably know the Petroleum sector plays a predominant role in the Norwegian economy. Oil and gas is by far Norway's single most important export article (47%), contributes by around one fifth to the Norwegian GDP, consumes one fourth of total investment about the same size as its contribution to the government's revenues. In 2010 Norway was the seventh largest oil exporter in the world and the second largest gas exporter (after Russia). The development of new discoveries should create the largest possible value for the nation. It will therefore also provide local and regional ripple effects.

But since the audience here consists of tax people and not macroeconomist I will focus on the Government's revenues from the petroleum activities, and how this is collected. But before entering this subject I must present the framework and organization of the petroleum sector in Norway and also provide some information on how

the taxation of oil companies and related activities is organized within the Norwegian Tax Administration (NTA).

## **1.2. Legal framework for the oil companies**

The Norwegian Petroleum Act (ACT of 29 November 1996) contains the general legal basis for the licensing system governing Norwegian petroleum activities. The act confirms that property rights to the petroleum deposits on the Norwegian continental shelf as vested in the State. Official approvals and permits are necessary in all phases of the petroleum activities, from award of exploration and production licenses to plans for development and operation and plans for field cessation.

## **2. ORGANIZATION OF THE TAX AUDIT ACTIVITY**

Different parts of NTA are involved in different phases of the petroleum exploitation

Before any production, transportation and processing of petroleum can take place one must of course find the oil and gas. Exploration wells have to be sunk to verify the presence of significant volumes of oil and, given the cost of drilling; it has become imperative to minimize the risk of repeatedly ending up with dry wells. These highly specialized and often rather small companies are not assessed at the Oil Taxation Office (OTO) but at the Central Office of Foreign Tax Affairs (COFTA).

As long as they are not an intra - group company.

COFTA also assess the companies involved at construction of the rigs, supplying the rigs (services, catering etc.). Some of the major challenges COFTA faces are to make decisions regarding whether some form of activity or service delivery is to be considered as having taken place through a permanent establishment and therefore liable to pay corporate tax to Norway. Transfer pricing issues in the cases when the company operating on the Norwegian Continental Shelf receives services and funds from companies within the same group is another important working area. COFTA is also responsible for the registration of employees who are only temporarily working in Norway in petroleum related activities on the continental shelf. In the following I will not cover COFTA's role in the Norwegian oil taxation system any further, since the big oil tax money is collected elsewhere, that is at the Oil Taxation Office.

## **2.1. The Norwegian petroleum taxation system**

The petroleum taxation system is based on the rules for ordinary corporate taxation, but specified in the Petroleum Taxation Act (Act of 13 June 1975). Due to the extraordinary profit associated with exploiting the petroleum resources, an additional special tax is levied on this type of commercial activity. The ordinary tax rate is the same as on land 28%. The special tax rate is 50%.

When one calculates the basis for ordinary and special tax, investments are subject to straight-line depreciation over six years from the year they were incurred. Deductions are allowed for all relevant costs, including costs associated with exploration, research and development, financing, operations and removal. Consolidation between fields is allowed.

To shield normal return from special tax, an extra deduction is allowed in the basis for special tax, called uplift. This amounts to 30% of the investments (7, 5% per year for four years, from and including the investment year).

## **2.2. Norm price**

The production from the Norwegian continental shelf is largely sold to affiliated companies. To assess whether the prices set between affiliated companies are comparable to what would have been agreed between two independent parties, the Petroleum taxation act states that norm prices can be stipulated for use when calculating taxable income for the purpose of the tax assessment.

The Petroleum Price Board sets the norm price, which aims to reflect what the price could have been sold for between independent parties. This system applies to certain grades of crude oil and NGL. For gas, the actual sales prices are used as the basis.

## **2.3. Audit of the oil companies**

The tax assessment period 1. May – 30. November and the primary task in this period is to verify the information given in the tax return and its attachments.

The Oil Taxation Board decides the assessment of each company in meetings.

OTO staff divided into 3 teams responsible for a portfolio of companies and the teams consist of economists and lawyers. Two to six staff is allocated to each company and there is a rotation of team members after 3-4 years, to make OTO less vulnerable for staff turn-over but also for integrity reasons.

A thorough examination takes place every year of the about 80 companies assessed by the OTO and extensive correspondence (100-150 letters per (major) company) by sending standardized letters made by teams of employees with special knowledge about various issues.

Tax returns vary from about ten to several hundred pages and relatively few compulsory and standardized forms are attached. Letters of notification are sent to tax payers and an extensive report on each company prepared for the Oil Taxation Board (with the OTO's recommendation). All this audit or control work is undertaken through desk audits. Most of the reassessments done by OTO is related to transfer pricing issues.

### **3. TRANSFER PRICING ISSUES AT THE OIL TAXATION OFFICE**

#### **3.1. Intra –group sales of petroleum products**

As mentioned before the price for crude oil is set by a Price Board and this arrangement reduces OTO's need to check the companies' sales price in relation to the arm's length principle. Still some control is necessary to ascertain that the companies use the norm price in the correct way.

For dry gas the situation is quite different for although technically speaking dry gas is a homogenous product, which should make it easier to find comparable prices, the market contracts often includes clauses that can influence the market value considerably, and assessing the economic value of these clauses is a really difficult task..

#### **3.2. Intra-Group insurance companies (“captives”)**

It is common that oil companies chose to insure themselves through an insurance company within the group, so-called captives. The captive is often registered in a tax haven and will usually enter reinsurance contracts in the market. The issue here is firstly whether the captive has the financial strength to cover insurance claims that might occur in connection with casualties, that is whether the captive

is offering real insurance. If the answer to this question is yes, the next question is whether the price for the insurance is set at a market rate.

### **3.3. Intra-group loans**

Oil companies operating on the Norwegian continental shelf can claim deductions in their taxable income according to special thin capitalization rules. This right to deduct financial costs might produce incentives for the companies to borrow from other companies within the group that are established in low-tax jurisdictions. OTO gives mainly three issues attention: 1) choice of base interest rate and maturity; 2) the margin mark-up (the difference between the interest rate paid by the company and the base rate, reflecting the company risk); 3) other costs.

A big challenge is to which degree being part of a group should influence on the interest rate setting. This group relationship can explain the size of the divergence from the market rate measured by the base rate. Typical factors that might have relevance for the interest rate are the mother company's financial strength and the how close the group affiliation is.

### **3.4. Intra-Group services ("Overhead")**

The oil companies' purchases and sales of intra-group services have increased substantially the last years and now constitute significant amounts. A major reason behind this is restructuring of the companies and strong growth in the number of companies operating on the Norwegian continental shelf since 2004.

Intra-group services typically consist of administrative services such as accounting, tax, finance and IT; technical services related to geology, drilling and production, and research and development. Again two questions will be raised by OTO: 1) has the service really been delivered to the oil company; 2) if it has been delivered was it purchased at arm's length price?

If the oil company cannot provide documentation that the service was actually provided, OTO might refuse the cost as a deduction for tax purposes.

### **3.5. Desk vs. field audits**

Previously OTO did many field audits with a broad scope but today only a few tax audits, maybe 2-3 per year is carried out and then on specific issues. Why has this change happened? One reason is that experienced staff in oil companies is generally cooperative, and most information can be obtained through correspondence and more informal meetings. OTO's experience is also that in most cases the quality of the accounts can be trusted:

Mainly multinational companies operate on the Norwegian continental shelf. These oil companies are obliged to undergo external audits according to company regulations in Norway. In addition they also experience partner audits, head office audits, internal audits and due to all this different audits there are good reasons for not have any suspicion of fraudulent behavior or deliberately giving incorrect information

OTO's strategy for improving compliance has been to have a highly educated and skilled that is good at working in teams on complex issues, to have good knowledge of the oil industry, technology, products and markets, and integrate competence in legal and business/economics issues

How can OTO be sure of the quality of its work? For several reasons: 1) the decisions are made by independent boards, 2) memos and technical calculations are controlled by (at least) one other employee, and 3) OTO /the Norwegian State often win lawsuits.

### **4. FUTURE CHALLENGES**

In Norway's case the arrival of smaller oil companies on the Norwegian continental shelf is a challenge since some of these companies don't have the same capacity and competency in tax matters. Also new waves of company restructuring can make the future even more challenging for OTO.

### **5. CONCLUSIONS**

To collect the right amount of petroleum tax is a challenging task!  
Extensive

Knowledge of the industry is indispensable for good results. Strong professional competencies are needed in the oil taxation unit and experience teaches us that intra-professional teams solve the cases

best. Desk audits is often more efficient and certainly cheaper than field audits but this of course depends on the climate between the tax administration and the oil companies. Mutual respect and trust are key elements in this relationship and must build over time.