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Mr. David Prenzler  
Public Groups & International  
Australian Taxation Office

*By email*

14 February 2017

**RE: Transfer pricing and profit attribution guidance in relation to foreign resident vessels operating in Australia and cross border asset leasing**

Dear Mr. Prenzler:

The International Association of Drilling Contractors (IADC) appreciates this opportunity to participate in the Australian Taxation Office (ATO) consultation and comment on the December 2016 ATO guidance document you circulated to us on 16 December 2016 entitled '*Transfer pricing and profit attribution guidance in relation to foreign resident vessels operating in Australia and cross border asset leasing*' ("Guidance" or "Guidance Document").

The IADC is a member driven organization representing the worldwide drilling industry since 1940. As a trade association, IADC's purpose is to advance drilling and completion technology, improve industry health, safety, environmental and training practices; and champion sensible regulation and legislation that facilitate safe and efficient drilling. One of the IADC's central missions is to serve as a conduit for members to exchange information and better understand the latest developments affecting the drilling industry, including taxation.

Our comments focus on several key areas of concern given the unique characteristics of the drilling industry. They are not designed to be comprehensive and should be considered jointly with the comments provided by advisors to the 26 December 2016 Guidance Document and the 24 December 2015 draft, including those provided by PwC.

We thank the ATO and the members of the Lease in Lease out (LILO) Project team for the work they have undertaken.

**Offshore Drilling Industry Background**

The offshore drilling industry provides contract drilling services to the offshore oil and gas ("O&G") industry. The offshore drilling industry is a capital intensive business providing drilling services in exchange for payment, called a day rate. We use a Mobile Offshore Drilling Unit, also known as a drilling rig or rig, to provide specialized drilling rigs to drill wells on behalf of sophisticated oil and gas exploration companies ("Customer") who own the concessions or licenses necessary to develop the prospects anywhere in the world. As an industry we must be organized to move our drilling rigs and resources wherever the Customer demands in a cost-

effective and efficient manner. We are therefore organized in a way that will minimize the cost to our customers and allow a resource to be developed by the resource owner in a low cost manner. This includes centralized ownership of our rigs, which increases mobility and minimizes costs.

The demand for our drilling rigs, and the drilling services the rigs enable, is dependent on the exploration budgets of our O&G customers and the specific drilling program they plan to implement. As such, we are dependent on the fluctuation of oil prices and the decisions of the O&G industry. Like the O&G industry and other oilfield service providers, the drilling industry is a cyclical business regularly experiencing periods of feast and famine. When times are good, our rigs are utilized and we provide services, earning a return commensurate with the value placed on the service by our O&G customer through a drilling contract. Once the contract is over, the relationship with our customer ends and we gain no further return.

Unlike the O&G industry and other oilfield service providers, demand for the offshore drilling industry rigs, services and revenue ends once the drilling program ends. We do not earn an income stream from developing the resource (which is owned by the O&G companies) or have long term support contracts supplying services or equipment when the prospect is developed.

Given the nature of the offshore drilling industry and the presence of numerous competitors, the structure of drilling companies has evolved over time into an efficient structure which provides global services by separating rig ownership from the operating companies. The structure allows a customer to place a drilling rig anywhere in the world where they have a need to drill a well, while minimizing costs. As in all industrial markets like the drilling industry, price tends to be the single most important determinant of winning a job.

## **General Comments**

The IADC commends the LILO Project team for providing guidance to ATO staff on the transfer pricing and profit attribution issues in relation to the leasing of offshore vessels in Australia. The IADC welcomes practical guidance in applying Australia's transfer pricing and profit attribution rules to this complex area. The IADC agrees that there are a wide variety of different facts between, and within, the industries involved in the use of vessels. Each segment in the offshore industry has different market factors which impact the arm's length result when all relevant facts and circumstances are considered. As stated in paragraph 3 of the Guidance Document, the IADC agrees that the principles contained in the Guidance should be considered in relation to the taxpayer's actual transactions and dealings, after making the appropriate adjustments for the specific facts and circumstances.

Regrettably, the Guidance describes its approach to a bareboat lease under a LILO structure based on a simple example not generally found in the offshore drilling industry. Conclusions from the example are used to summarize the principles and approaches the ATO staff should use when applying the transfer pricing and permanent establishment attribution rules to the LILO leasing arrangements of vessels. While the Document states appropriate adjustments should be made to adjust for the facts and circumstance of the individual company, the Document does not provide guidance on what types of adjustments may be encountered and how to make the adjustments. This makes it difficult for the IADC to evaluate how to apply the approach to its specific fact pattern and for the ATO to receive comprehensive comments that

take into account the complexities of the offshore industry, the unique market conditions, its diverse business models, and contributions of each related-party to the value earned by the industry.

Moreover, the example describes the activities of the Sub-Lessee, Sub- and Head-Lessor drawing a bright line between the functions performed by each party. However, the analysis primarily focuses on the activities of the Sub-Lessee (albeit without great detail) without a detailed discussion of risks assumed by other entities or how value is created by each entity contributing value to the Multinational Enterprise (MNE). The contribution of each entity to the value created requires more than just a detailed analysis of each entity's functions, assets and risks. It also requires an analysis of how value is created within the industry, based on what the customer values when entering into a customer contract.

In the drilling industry, value is created by the MNE delivering a rig that will perform the customer's drilling program and then drilling the well contained in the drilling program. The role of the rig in creating value is apparent in the customer contract and the amount of effort goes into ensuring the correct rig is delivered. It is also seen in the economics of the offshore drilling market. When there is a shortage of rigs, the value of the service and the contract performed by the Sub-Lessee goes up. When there is a surplus of rigs, then the value of the contract drops. The offshore drilling industry is currently experiencing a surplus of rigs, which has dropped the value of the rigs. The value received by the MNE is based on the rig which the Sub-Lessee acquires to perform the customer contract. The higher the value of the rig, the higher the day rate received and the higher the value of the customer contract.

The challenge in determining the arm's length price for the rig and return for the Sub-Lessee is distinguishing between the value of the rig when used in delivering the customer contract and the value created by the Sub-Lessee in delivering its services when using the rig in the performance of the customer contract.

The IADC encourages the ATO to provide examples that more closely represents how each segment of the offshore industry operates, conduct a value chain analysis of each example, and provide guidance on how adjustments should be made. As currently presented, the IADC disagrees with the ATO's statement that the *principles outlined in this document should be relevant to most, if not all, LILO arrangements*.

### **Specific comments**

The Document's section entitled 'Key principles to consider in relation to bareboat arrangements' ("Key Section") makes several statements based on the example provided in Appendix A of the document. These statements would benefit from a more detailed and complete functional analysis presentation based on more realistic assumptions. Throughout the Key Section and different sections of the document the Guidance refers to properly rewarding each entity based on its contribution. For example the Document states the methodology used to *'determine the arm's length profit arising from the Sub-Lessee must give proper regard to the functions performed, assets used and risks assumed by it and reflect the contribution it makes to the MNE's business*.

The IADC agrees with the ATO that the arm's length reward to each entity should reflect its contribution to the MNE's business. This requires that all entities contributing to the core business, irrespective of where they are located, be rewarded according to what they bring to the customer's contract. In the Guidance's example, the contributions of the entities included in the example are clearly defined. It is the drilling industry's experience that the Sub-Lessee rarely can deliver the customer contract on its own accord once it receives a rig and is dependent on other related entities, and not necessarily only the rig lessor, to fulfill the customer contract. The contribution of these entities should be addressed. Without more detailed examples of each entity's contribution to the value chain, the IADC disagrees with the statement that ... *Sub-Lessee essentially is performing the third-party customer contract and thus, the core business of the MNE. Performing a contract, even a complex contract, does not in itself mean the value paid by the customer is created only by performing the contract.* As stated above, the customer first demands a rig, and then looks toward the drilling contract.

The IADC requests further clarification on the Guidance's statement in the Key Section that states *[w]here a company operates a vessel in Australian waters, in working out the return to the Sub-Lessee or in the alternative, the Sub-Lessee's Australian PE, it must be recognised that the Sub-Lessee (or its Australian PE) is using a substantial asset in its own right and often providing specialised services that depend on the relevant expertise of its personnel.* The IADC recognizes that the customer contract uses the vessel (rig) to fulfill its contractual obligation. However, it is not clear from the statement that the Guidance is distinguishing between 1) the value created by the Sub-Lessee in delivering its services when using the vessel, and 2) the value of the rig when used in delivering the contract. As stated above, the customer demands both the specific rig and the well drilling services. However, the contribution of the customer contract to the MNE is primarily driven by the economics of the rig market. The service component of the customer contract, and therefore the profitability of the Sub-Lessee, should be analyzed based on the activities of the Sub-Lessee separately from the rig value. The IADC is particularly concerned because the Guidance does not separate the two value drivers when developing its risk indicator benchmarks in Appendix B.

#### **ATO's comments on adopted transfer pricing methods**

In Appendix A, the Guidance states that *"[a] cost plus return applied to the Sub-Lessee is very unlikely to be appropriate because the Sub-Lessee does not undertake activities whose value is reliably measured by reference to their cost, as it holds and fulfils the customer contract, holds the crewing contracts and operates a vessel that has substantial risk."* The Guidance also stated in the Key Section the *"ATO staff will scrutinise arrangements under which the Sub-Lessee is given a limited return for its activities (such as cost plus) that does not reflect that it is conducting specialised and risky activities that are integral to the performance of the third-party customer contract."*

The IADC believes both statements are inconsistent with other parts of the Guidance, particularly where the Guidance states the *"methodology used to determine the arm's length profit arising to the Sub-Lessee must give proper regard to the functions performed, assets used and risks assumed by it and reflect the contribution it makes to the MNE's business."* The IADC believes all transfer pricing methods can be appropriate depending on the facts and circumstances of the transaction and the functions performed, risks incurred and assets used by

each entity in earning an arm's length return. As long as the arm's length result is achieved, the industry should not be restricted in the transfer pricing method to achieve the result.

The IADC would encourage the ATO to clarify why the cost plus method is not appropriate to be used as a method for achieving an arm's length result if it properly reflects that functions performed, assets used, and risks incurred.

The fundamental issue addressed by the Guidance is what price the Sub-lessee would be willing to pay to lease a vessel in order to provide the services contained in the customer contract given the market in which it operates. Drilling industry customer contracts for a specific rig based on the needs of their drilling program and to drill the wells in the drilling program. If a Sub-Lessee was the main driver of the relationship with the customer, the Sub-Lessee would need to acquire a rig. It could purchase a rig or lease a rig. If it chooses to lease the rig because purchasing was uneconomic, then it would evaluate the price it is willing and able to pay for the rig from the third party by evaluating its earnings and profitability after it pays for the rig. If the return from leasing the rig meets the company's profitability criteria, it would enter into the lease agreement. That is, the cost of the vessel generally is not included in the decision. Fundamental to the decision is the fact the Sub-Lessee cannot fulfill the customer contract without acquiring the right rig.

### **Role of the Sub-Lessee**

The Guidance states in paragraph 42 that *where agreed sub-lease conditions are such that the Sub-Lessee is expected to generate a loss from its activities, then again, it is unlikely that comparable circumstances could be identified to match this type of arrangement.* This statement appears inconsistent with the Guidance's statement that the Sub-Lessee is performing the core business of the MNE, carrying significant risk associated with performing the core business. If, like the Guidance states, the Sub-Lessee functions performed and risks incurred are the primary contributors to the value of the MNE then the Sub-Lessee would expect to also incur losses. In third-party vessel lease arrangements, the Sub-Lessee would be expected to pay the lease payment irrespective if the customer contract was profitable or not. In fact, the lease payment would be one of the primary costs the Sub-Lessee pays. If the Sub-Lessee failed to pay the lease payment, then the Lessor would reclaim the rig and the Sub-Lessee would be unable to perform the customer contract resulting in greater losses. However, the fundamental assumption that the Sub-Lessee is the primary value driver is incorrect as it relates to the drilling industry. As stated above the primary driver is the demand for the rig.

The IADC is concerned that the Guidance may not provide sufficient guidance to allow ATO staff to apply the guidance in a consistent manner.

### **ATO risk evaluation and risks indicators**

The ATO's Guidance assigns a risk indicator to Sub-Lessees in the offshore drilling industry of 12% based on an EBIT on sales margin benchmark, after any lease payments. The Guidance does not discuss the economic rationale for arriving on the risk indicator, the rationale for choosing the indicator, or provide a description of the entities used as comparables.

The IADC is concerned that the ATO assigned a risk indicator value and profit level indicator that is unrealistically high and does not realistically represent the arm's length results of each related party's economic contribution to the transaction and the MNEs. It is difficult for the IADC to comment on the risks indicators without better understanding the basis for risk indicators. As discussed above, offshore drilling industry customers place value on the drilling rig based on their perceived value of the functions performed and assets brought to the contract. The risk indicator and its threshold value should reflect the industry that is being analyzed.

The IADC is also concerned that by assigning an unrealistically high value to the risk indicator, the ATO guidance does not achieve its stated purpose to evaluate if the amount of tax brought into Australia is consistent with an arm's length leasing arrangement. The IADC encourages the ATO to reassess its risk indicator based on the offshore drilling industry's value chain and each a more typical set of facts and circumstance.

### **Alternative arrangement and notional leases**

The IADC would appreciate greater guidance on why the ATO is '*unlikely to accept that a notional lease approach is appropriate.*' The concept of the notional lease is consistent with Tax Ruling TR2001/11 and the concept of attributing profits to a PE as if it is a hypothetical separate entity dealing at arm's length with its head office (as required under Australia's transfer pricing rules for PE profit attribution). When the separate entity analysis is applied to the same set of facts and circumstances, such as those in the example in Appendix A, one would expect the service component of the contract to earn the same arm's length result as the Sub-Lessee in Appendix A. It is entirely reasonable for an MNE enters into a leasing agreement between two related entities or a notional lease.

### **Other comments**

The Guidance provides guidance in a complex area where industry segments have differing facts and circumstances. The following comments are provided in an effort to seek additional clarity or were not addressed in the Guidance but warrant being included.

Utilization risks - The Guidance does not address utilization risks, the offshore industry's, and particularly the offshore drilling industry's, biggest risk. The Guidance focuses on the period when the vessel is under contract and the Sub-Lessee is using the vessel to provide the service. The Guidance does not discuss what happens if the customer contract is cancelled or if there is an interruption in services. In the offshore drilling industry when a contract is completed the Sub-Lessee typically returns the vessel to the rig owner (Sub-Lessor). The Sub-Lessee does not incur utilization risks outside the customer contract. The IADC believes a properly performed FAR analysis would include the utilization risks of each entity.

Intercompany agreements - The IADC noticed that the Guidance does not address the role of intercompany agreements. Intercompany agreements are common in the offshore industry. They define the activities performed and the risks incurred by each party to the agreement. Properly analyzing the intercompany agreements is an important part of the transfer pricing analysis, based on the OECD Guidelines and under Australian transfer pricing rules. We recommend the Document be give guidance to the ATO staff on the role of intercompany agreements.

Sub-Lessee services - The Guidance states that a cost plus return may be the appropriate the starting point for recognizing the contributions of the Sub-Lessor (and presumably the Head-Lessor if the two entities activities are taken together) and listing in Paragraph 49 the services which may be performed by the Sub-Lessor. The Guidance also recognizes that the Sub-Lessor may perform more than routine activities which can command greater profit than a cost plus. The IADC recommends that the ATO provide more guidance on the types of services and when they may be considered non-routine, thereby commending additional returns. Also, the Guidance should distinguish between services which should be separately charged and those which are part of the lessor's functions.

Additional examples - The Guidance would benefit from additional examples which are embedded in real life examples for the different offshore industry segments. The Guidance provides a single solution for such diverse activities as tug boats, pipe laying, dredging and drilling. The value chain of each of these offshore segments can be significantly different. By including real life examples, ATO staff will have additional guidance as they analyze the complex facts and circumstances they will encounter.

## **Conclusion**

The IADC appreciates the opportunity to comment on the Australian Taxation Office's guidance paper entitled '*Transfer pricing and profit attribution guidance in relation to foreign resident vessels operating in Australia and cross border asset leasing*' issued on 16 December 2016. The IADC would be happy to discuss our comments on the ATO's guidance and would appreciate the opportunity to speak in support of these comments at a public consultation.

If you have any questions about the submission, please contact Dr. Clifford Mangano at Cmangano@dodi.com or Mr. Steve Hayes at Steve.Hayes@deepwater.com, as representatives of the IADC tax committee or the IADC Tax committee liaison, Elizabeth Craddock at Elizabeth.Craddock@iadc.org.

Sincerely yours,

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IADC Tax Committee