Kluwer International Tax Blog

Windfall profits in the Energy Sector in 2022: Which entity in the group should capture them? – A transfer pricing perspective

Svitlana Buriak, Jan-Willem Kunen (Loyens & Loeff, Netherlands) · Thursday, January 26th, 2023

Energy security and energy prices have become one of the biggest economic challenges for the world right after the global pandemic. Commodity prices for coal, oil and gas increased sharply in 2022.[1]

The soaring prices have generated abnormally high profits in the energy sector. In response, in September 2022, the European Union (**EU**) has agreed to implement a windfall tax on the record profits of energy firms as an emergency measure. The EU Council Regulation on an emergency intervention to address high prices of 6 October 2022, laid down the temporary rules for taxing 'surplus profits generated by Union companies and permanent establishments with activities in the crude petroleum, natural gas, coal and refinery sectors'. This measure also includes a price cap on market revenues for certain electricity producers.

What is a windfall tax?

In general, a windfall tax is a tax on abnormal returns of companies that arise not due to the actions and decision of an investor, but from an unanticipated event like, for example, the COVID-19 pandemic or the Russian invasion of Ukraine.[2] History shows that similar taxes were introduced, for instance, also during the First and Second World Wars in the United States to "syphon off war profits".[3]

The EU Council Regulation defines the surplus profit, or the 'windfall profit' as the profit calculated under national tax rules that is above a 20% increase of the average of the taxable profits starting on or after January 2018.[4] The applicable rate for the windfall tax is left to the consideration of Member States, but should be at least 33%.[5] Some Member States went far beyond this minimum rate.[6]

Why windfall profits are peculiar from a transfer pricing perspective?

Since the proceeds from the windfall tax will be used to provide financial support for households and energy security projects, it is fair to expect that for governments the following question becomes important: Which entity or permanent establishment (**PE**) in large multinational groups accumulate the windfall profits and hence which jurisdiction will be entitled to tax it at an extraordinarily high rate?

For example, let us assume that for Multinational Enterprise A, a natural gas field, facilities and production are located in Norway. However, key-management people who are responsible for strategic decision-making including purchasing additional production equipment and concluding long-term sales agreements, are located in Denmark and the United Kingdom (**UK**). Which jurisdiction should in such a case be entitled, from a transfer pricing perspective, to tax the excess profit in 2023: Norway, where the gas reserve, facilities, and production with personnel are located or Denmark and the UK, where the key decision-makers are based?

What the OECD Transfer Pricing Guidelines have to say about the allocation of windfall profits?

The current practice of many jurisdictions following the 2022 OECD transfer pricing guidelines (**OECD TPG**) is to follow the approach of significant people functions for profit allocation: people perform functions, people use assets, people assume and control risks – hence people are considered to generate profit. For legal entities, under this practice the ones that are entitled to most of the profit are those who take strategic decisions and control risks.[7] In this respect, the OECD TPG distinguish between (i) policy setting and (ii) actual decision making[8], but the way that this distinction should be applied in practice is in our view far from clear.

For attribution of profits to a PE a similar approach is often applied in many jurisdictions. First significant people functions have to be determined: assets and risks will then be considered following these people functions. Such an approach increasingly relies on an evaluation of decision-making by individuals and their ability to be on top of every risk factor that affects the profitability.[9] In our example, it would mean that Denmark and the UK, in principle, under this approach should be entitled to tax the residual profit, which includes the windfall profit, since significant people functions are performed there.

The question is though whether this is a correct application of the arm's length principal and that indeed these high profits can be attributed to strategic key decision-making. Could the key decision-makers in our example anticipate the COVID-19 pandemic and the Russian invasion of Ukraine? This question is of course theoretical, since hardly anyone could have predicted this in advance. Yet, the question demonstrates that there are many issues that are outside the control of key decision-makers that can dramatically affect the profitability of a business.

What assets tend to generate economic rents incl. windfall profits?

The name and the very nature of windfall profits suggest that such profits are unexpected and sudden – blown down by the wind. The EU Council Directive explains that 'those profits do not correspond to any regular profit that Union companies or PEs with activities in the crude petroleum, natural gas, coal and refinery sectors would or could have expected to obtain under normal circumstances, had the *unpredictable events* in the energy markets not have taken place'.[10] Baunsgaard and Vernon in an IMF Policy Note also highlight that 'windfall profits arise from an unanticipated event unaffected by the actions or decisions of an investor'.[11] Hence, if windfall profits are not a direct result of the functions performed or risks assumed by an investor, the question of where these profits have to be attributed remains open.

Natural resources belong to the group of economic rent, or economic profit, generating assets. Economic rent refers to the profit that is above the normal rate of return. Economic rent is not the same as windfall profits since economic rents can also arise in normal market conditions not affected by unexpected economic conditions. However, economic rents, in principle, should comprise windfall profits if the methodology for their determination is appropriate.[12] Rent-generating assets is the category of assets that has the potential to generate excess returns beyond the normal return on factors of production (functions, assets and normal risk) when there are certain structural abnormalities in the market conditions.[13] Besides extractives and other natural resources, intellectual property, for example, also belongs to this category.

When economic rents including windfall profits materialize and how to deal with them under the OECD TPG?

It is important to highlight several considerations regarding economic rents. First, they materialize not only when unpredictable events trigger windfall profits, but also due to a number of other factors that result in an imbalance between supply and demand in the market and the scarcity of a rent-generating asset, e.g., (i) political interventions; (ii) natural monopolies; (iii) anti-competitive behaviour and market monopolization; (iv) control over the access to consumers' markets by digital gatekeeper platforms.[14] Hence, the problem of addressing the transfer pricing treatment of excess profits is not limited only to windfall profits in the energy sector.

Second, in transfer pricing terms, as suggested by Hebous et al., the category of economic rents can conceptually be deemed equal to residual profits, but not always technically equal. In this regard, the OECD Pillar One Project has recognized that the residual profit can arise not only due to functions, assets and risks but also due to other factors, such as the consumer market. However, the current OECD TPG, Pillar One and Pillar Two projects operate similar terminology, i.e. residual profit, but attribute different meaning to the term creating potential disparities.

It is time now to develop a conceptual understanding of what residual profits indeed are and the factors besides functions performed, assets used and risks assumed, that lead to the ability to accumulate them.

Where to allocate the windfall profit now in the absence of OECD guidance?

For the present financial period and the energy sector, a question for the excess income allocation would be the location of the rent-generating assets, since it can be considered one of the main sources and cause of economic rents. Of course, a case-by-case analysis may result in a different assessment depending on the actions performed by the key personnel, for example, to hedge risks or conclude certain contracts, as well as depending on the timing of these actions. Nevertheless, there would be solid arguments to take the position that the location of the asset is to be considered a key factor for allocating windfall profits in the energy sector.

What about 'windfall losses'?

Finally, unpredictable events can result both in a profit or loss situation for the business, which was clearly evident during the COVID-19 pandemic when the same energy sector suffered losses due to a rapid decrease in demand – we could call them then 'windfall losses'. In this regard, any solution for allocating windfall profits in transfer pricing has to apply coherently both for profit and loss situations.

[1] Baunsgaard, M. T., & Vernon, N. (2022). *Taxing Windfall Profits in the Energy Sector*. International Monetary Fund.

[2] Ibid.

[3] See, Avi-Yonah, R. S. (2020). Taxes in the Time of Coronavirus: Is It Time to Revive the Excess Profits Tax?. *U of Michigan Public Law Research Paper*, (671), 20-008, p. 1; Christians, A., & Diniz Magalhães, T. (2020). It's Time for Pillar 3: A Global Excess Profits Tax for COVID-19 and Beyond. *Tax Notes International*, 507-510. Hebous et al (2022) provide a historical overview of excess profit taxes ever introduced by different states and consider that this type of taxes was always introduced on a temporary basis mainly motived by revenue needs. Hebous, S., Prihardini, D., & Vernon, N. (2022). Excess Profit Taxes: Historical Perspective and Contemporary Relevance., p. 9.

[4] Art. 15, Council Regulation (EU) 2022/1854.

[5] Article 16(2) Council Regulation (EU) 2022/1854.

[6] See, C. Enache, What European Countries Are Doing about Windfall Profit Taxes, Tax Foundation 4 Oct. 2022 (last accessed 20 Dec. 2022)T. Paraskova, Italy expects to raise $4.2 billion from windfall tax and power price cap, *Oilprice 5 Dec. 2022*, last accessed 12 Dec. 2022; J. Tenwick, EU Energy Windfall Tax: European countries must aim0 for 50 – 90 percent rate and not let other profiteering industries off the hook, Oxfam International 30 Sept. 2022, last accessed 12 Dec. 2022.

[7] TPG 1.105. 'A party should always be appropriately compensated for its control functions in relation to risk. Usually, the compensation will derive from the consequences of being allocated risk, and therefore that party will be entitled to receive the upside benefits and to incur the downside costs. In circumstances where a party contributes to the control of risk, but does not assume the risk, compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate.'

[8] See paragraph 1.76 OECD TPG

[9] R.S. Collier & I.F. Dykes, On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines: Risk and Post-BEPS Problems for the Arm's Length Principle, 76 Bull. Intl. Taxn. 1 (2022), Journal Articles & Opinion Pieces IBFD (accessed 6 Dec. 2022).

[10] Recital 14, Council Regulation (EU) 2022/1854.

[11] Baunsgaard, M. T., & Vernon, N. (2022), supra n 1, p. 4.

[12] Ibid.

[13] Magalhães, T. D., & Christians, A. (2020). Rethinking tax for the digital economy after COVID-19. *Harv. Bus. L. Rev. Online*, *11*, 1, p. 12.

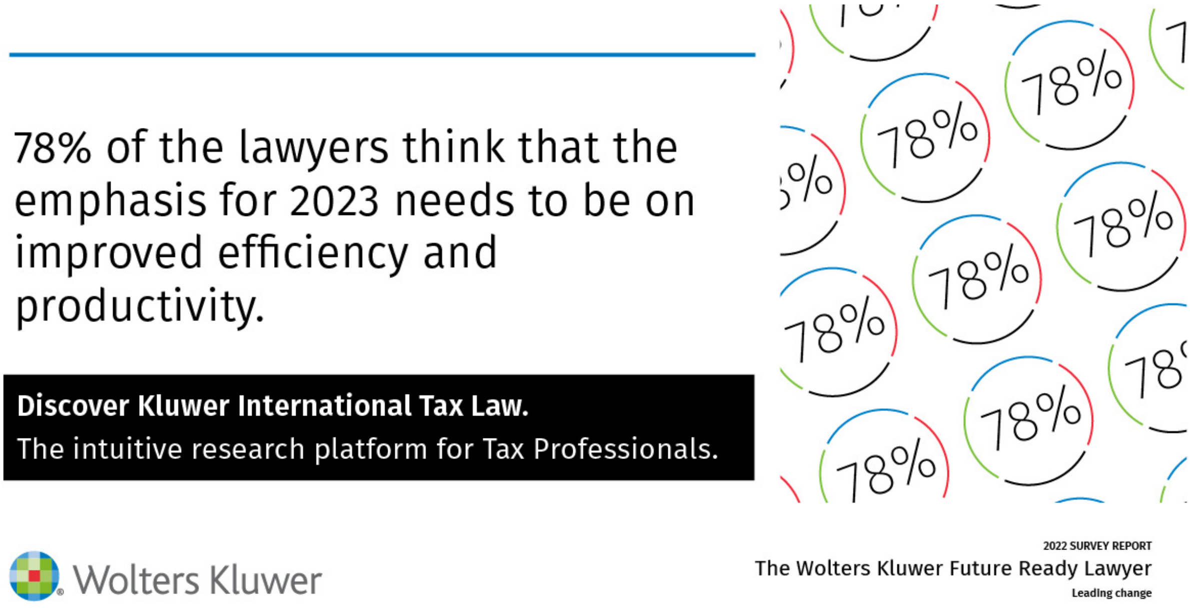
[14] G. Schwerhoff, O. Edenhofer & M. Fleurbaey, *Taxation of Economic Rents*, 34 J. of Econ. Surveys 2, p. 412 (2020); Shay S.E., The Deceptive Allure of Taxing "Residual Profits", 75 Bull. Intl. Taxn. 11/12 (2021),, at sec. 3.2.

To make sure you do not miss out on regular updates from the Kluwer International Tax Blog, please subscribe here.

Kluwer International Tax Law

The **2022 Future Ready Lawyer survey** showed that 78% of lawyers think that the emphasis for 2023 needs to be on improved efficiency and productivity. Kluwer International Tax Law is an intuitive research platform for Tax Professionals leveraging Wolters Kluwer's top international content and practical tools to provide answers. You can easily access the tool from every preferred location. Are you, as a Tax professional, ready for the future?

Learn how **Kluwer International Tax Law** can support you.



This entry was posted on Thursday, January 26th, 2023 at 11:57 am and is filed under Energy, Transfer Pricing, Windfall tax
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.