HMRC - OT05025 - PRT: Computation - Arm's Length Rule

Disposals in sales at arm’s length

Under OTA75\SCH3\PARA1 a sale of oil is a sale at arm’s length if, but only if, the following conditions are satisfied with respect to the contract of sale:

the contract price is the sole consideration for the sale;

the terms of the sale are not affected by any commercial relationship between the seller (or a person connected with him) and the buyer (or a person connected with him); and

neither the seller nor any person connected with him has, directly or indirectly, any interest in the subsequent resale or disposals of the oil or any product derived therefrom. ICTA88\S839 (connected persons) applies.

This provision together with OTA75\S2(5)(a) and OTA75\S2(5)(b) (see OT05000) operate to impose stringent tests on a transaction before the price in the contract is accepted for PRT purposes. The transaction must first of all constitute a sale and it must then satisfy each of the three conditions. Given the way in which the legislation is written, the onus is on the company to show, effectively, that the transaction is a straightforward sale, untrammelled by any other transaction or commercial relationship. Transactions between unconnected parties, as well as those between group companies, can be caught and result in disposals being taxed at the statutory market value rather than at the price in the contract.

In interpreting this legislation it needs to be recognised that it contains a number of terms which have legal meaning in their context, for example, the terms “sale”, “contract of sale”, “price” and “consideration”. A sale is generally a disposal, or transfer of ownership in goods from seller to buyer, for a money consideration called the price. In any case where there is doubt about whether or not a disposal is made by way of sale, and whether a contract is a contract of sale (and the issue is material), copies of all the relevant documents should be obtained and advice sought from the Solicitor’s office.

This is also a difficult and sometimes contentious area as the oil markets have developed considerably in recent years; the number and variety of transactions, trading instruments and practices have increased; and some transactions and practices appear to be designed primarily to avoid PRT. In defining a sale at arm’s length, the legislation contemplates a simple sale of a commodity and although the nomination scheme introduced in 1987 effectively recognised the development of the Brent 15 day market, more recent trading practices, even if driven by purely commercial criteria, do not sit easily within this definition.

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Practice

Disposals of equity returned as arm’s length should be examined carefully. In most cases all contracts should be examined with the relevant return but where this imposes a heavy burden on a participator with many equity disposals, a representative sample may be agreed with the company. The database should also be scrutinised to look for trading patterns and evidence of the linkage of deals.

It is necessary here to have a good understanding of the market: the manner in which oil is disposed of and the various types of transaction used, for example, for speculation and risk management. This will give a better understanding of the transactions undertaken by the participator in question.

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Is the disposal of equity made by way of a sale?

In dealing with a specific case where a disposal of equity appears to be

connected in some way to another transaction, or

affected by another relationship, or

for a consideration (in whole or in part) other than cash,

it must first be established whether the equity disposal is made by way of sale. In some cases this is reasonably clear but others fall close to the dividing line, as illustrated by the following examples (which are based on actual cases).

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Parent company guarantees

It is not uncommon for a seller of oil to request his buyer to give security and this is sometimes provided in terms of a guarantee by the buyer’s parent company. Although each contract and guarantee will need to be examined and judged on its own facts, a simple guarantee of financial performance by the buyer’s parent is unlikely to result in a contract, which is arm’s length by all other criteria, failing the conditions in OTA75\SCH3\PARA1.

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OTA75\SCH3\PARA1(1)(c)

This section catches sales of oil to a participator’s fellow group or other connected companies to the extent that they are not already caught under subheads (a) and (b). OTA75\SCH3\PARA1(1)(c) applies, inter alia, where a person connected to the seller has an interest in the subsequent sale or disposal of the oil or the products derived from the oil.

It also catches, however, any repurchase from a third party. For example, A sells his equity to an unconnected company B who refines the oil and sells the naphtha fraction to A’s petrochemical affiliate. The sale by A to B is therefore not at arm’s length.

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On-sales

Interpretation for sales before 1st July 2006:

OTA75\SCH3\PARA1(1)(c) applies where the interest is direct or indirect. This therefore means that sales using net-back prices are not at arm’s length, e.g. A sells gas to B who sells to a range of end-users and the sale price payable to A is a proportion of the aggregate of B’s on-sale prices.

Interpretation for sales on or after 1st July 2006:

Such sales are now considered to be made on Arm’s length terms. For example, company A and company B are both 100% subsidiaries of company C. Company A sells all of its equity crude oil entitlement from Aardvark field to company B, which is the group’s marketing company. Company B then sells all of that oil and other oil that it has bought from third parties to another company, D, which has no relationship to A, B or C.

The terms of the “1st pass” sales from A to B are on a standard floating basis, based upon the average of a Price Reporting Agency’s benchmark crude oil assessments around the Bill of Lading, with a differential of $0.50 per barrel. The “2nd pass” sale from B to D is on the identical floating basis but with a differential of $0.55 per barrel. Because of the facts and circumstances surrounding the sales the difference of 5 cents is considered in this instance to be a reasonable marketing fee, so the price received by A is considered to be a reasonable arm’s-length price.

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