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Construction Contracts and Tax: A Splitting Headache?

January 16, 2018

*By: **Tom Swarbrick** and **Tracy London***

It has become common practice in many jurisdictions for parties to split construction contracts with an international element. The split structure is intended to provide a reduced tax exposure for the contractor and a resulting pricing benefit for the employer.

The archetypal contract split will see a single, turnkey contract split into onshore (or in-country) and offshore (or out-of-county) agreements. The contractor entity is usually different in each agreement. The various parties will then enter into a single umbrella agreement, which might also be called a bridging agreement, linkage agreement, coordination agreement or similar. This agreement will regulate the relationship between the onshore and offshore agreements. The primary purpose of the umbrella agreement is to ensure that the split structure offers the same contractual protection to the employer as a single, turnkey contract.

There is a commonly held view that the splitting of a construction contract can be concluded quickly and easily. It rarely turns out this way in practice. This is partly because the mechanics of the split will be driven by local law tax advice. It is also because the effect of the split on scope, pricing, liability and interface can be difficult for the parties to establish.

Historically, practitioners have not received a great deal of assistance from the courts in terms of how a tax split should be structured and drafted. For this reason, the recent decision in *Petroleum Company of Trinidad and Tobago Ltd v Samsung Engineering Trinidad Co Ltd* is very interesting reading. The decision in the case was ostensibly startling: in a claim for delay liquidated damages, Samsung would have the benefit of a lower cap in the onshore agreement. The overall liquidated damages in the linkage agreement would be ignored.

Parties might usually expect a higher aggregate cap in a linkage agreement to override any lower liability cap set out in the onshore and offshore agreements. The rationale is that any delay is typically attributable to the consolidated scope, rather than to the individual onshore or offshore elements. These elements are somewhat artificial, existing only to give effect to the tax split. That being the case, the case also validated a number of the protections that well-advised parties would typically include in a split contract structure.

Petronin v Samsung

The circumstances of the case concern a fairly typical dispute over competing entitlements to additional time and liquidated damages. Petroleum Company of Trinidad and Tobago Ltd ("

Petronin”) engaged Samsung for the procurement, construction and commissioning of a CCR Platformer Complex and substation in Trinidad.

The contract was split between an onshore agreement and an offshore agreement. A different Samsung entity entered into each agreement. The parties, including both Samsung entities, entered into a linkage agreement to regulate the relationship between the onshore and offshore agreements. The intention of the parties (which was not in dispute) was solely to achieve tax efficiency and the purpose of the linkage agreement was to ensure that there would be no derogation from the turnkey principle.

Samsung failed to achieve the required mechanical completion date and brought an arbitration for an extension of time, damages and sums. The claim was brought under the onshore agreement. Petronin counterclaimed for delay liquidated damages. An issue arose regarding whether the liquidated damages would be subject to a cap in the onshore agreement (sized at 10% of the onshore agreement price) or a cap in the linkage agreement (sized at 10% of the aggregate of the onshore agreement price and the offshore agreement price). The difference between the respective positions was a liability of almost US$2.3 million.

Which cap applied?

The arbitral tribunal held that the cap set out in the onshore agreement applied and found in favour of Samsung. Petronin challenged the finding in the English High Court. The Court agreed that the lower cap was correct and rejected Petronin’s argument to the contrary. The key reasons for the decision were as follows.

- Samsung brought the arbitration proceedings under the onshore agreement. The claimant was the onshore entity.
- Petronin’s counterclaim was stated to be brought against the onshore entity. Petronin did not indicate that the counterclaim was brought pursuant to either the offshore agreement or the linkage agreement.
- The terms of reference of the arbitration were drafted by reference to the onshore agreement.
- Petronin’s counterclaim referred to ‘a cap at 10% of the Contract Price’. The ‘Contract Price’ was a defined term describing the price in the onshore agreement. The overall price for both the onshore and offshore elements was defined in the linkage agreement as the ‘Total Agreement Amount’.
- As a matter of construction, if the tribunal were to import the linkage agreement cap into the onshore agreement, the effect would be to render the lower cap completely ineffectual. The correct view was that the lower cap applies and that the linkage agreement cap should be interpreted as ‘a long-stop limit for the aggregate of liquidated damages under all three agreements’.

What went wrong for Petronin?

The judgment must have been a bitter pill to swallow for Petronin, given that the sole reason for the split was apparently to achieve tax efficiency. Presumably, Petronin did not anticipate bearing any additional risk as a consequence of the split.

According to the judgment, the linkage agreement contained a number of the protections we would expect to see to protect the employer from assuming any residual risk. These include:

- an interface obligation to integrate the onshore and offshore scopes;
- provision to make sure one contractor could not obtain time or cost relief due to default by the other contractor; and
- wording to confirm the precedence of the linkage agreement for the purposes of interpreting any inconsistency.

However, these protections were redundant because the claim and counterclaim were pursued (initially at least) in relation to the onshore agreement only.

Petronin attempted, belatedly, to invoke the entirety of the contractual framework. Their reply to defence to counterclaim emphasised the interrelationship of the agreements, arguing that the required mechanical completion date was identical in each of the onshore and onshore agreements. The implication was that any delay to mechanical completion would be a function of delay in respect of both scopes. However, the tribunal, and subsequently the Court, rejected this narrative as being inconsistent with the mechanism by which the claim and counterclaim had been brought (namely by reference to the onshore agreement).

Implications for tax splits

The most evident lessons of the judgment are:

- a linkage agreement should contain robust protection against any adjustment of the risk profile of the construction contract which may arise as a consequence of the split;
- any claim or counterclaim should be made pursuant to the entirety of the contract framework; and
- the dispute provisions in the constituent agreements should enable the joinder of related disputes.

This last point is important to enable a respondent to ensure that any claim brought in relation to a single agreement can be determined by reference to the overall contract structure.

To split or not to split?

There is also a broader moral which parties should consider given the outcome of this case. Parties, and particularly employers, should spend time to determine whether a tax split will actually offer a discernible, worthwhile benefit. Typically, this would be a significant cost-saving. Often, international contractors will propose a split simply on the basis of accepted practice in other jurisdictions. However, it is not always advisable or even necessary. Certain jurisdictions offer tax exemptions which obviate the need for a tax split. In other cases, any financial saving may be minimal when considering the additional time and cost implications of negotiating and agreeing the split contracts (which, it is as well to remember, includes splitting scope and pricing schedules as well as legal terms).

In addition, the case provides a useful reminder to parties (particularly employers) of the additional burdens of a tax split. If the parties are well-advised, this should not amount to additional risk exposure. However, it will necessitate a greater degree of oversight to ensure that the contract is administered as a consolidated whole.