

Guidance Note on Permanent Establishments Issues for the Extractive Industries

Subcommittee on Extractive Industries Taxation Issues for
Developing Countries

United Nations

General PE Issues in the Industry

- **Relevance:**
 - Basic pillar for international taxation,
 - Increased interest in PE rules (e.g. BEPS),
 - Key element of taxation for resource-rich countries.
- **Complexity:**
 - PE concept can give rise to different interpretations,
 - Countries have implemented diverse PE thresholds in their tax treaties,
 - Both fixed and mobile activities are involved.
- **Case-by-case approach:**
 - Wide range of activities and number of actors, etc.,
 - Specific facts and circumstances of apply to each particular E&P phase,
 - Alternative tax provisions might apply to a singular case.
- **Purpose of the Note:**
 - To provide overview of most prominent PE tax aspects in the EI,
 - Assist in evaluating the different tax options available .

Upstream / Downstream



Upstream Industry

- Exploration
- Development
- Production

Downstream Industry

- Refining
- Marketing
- Trading

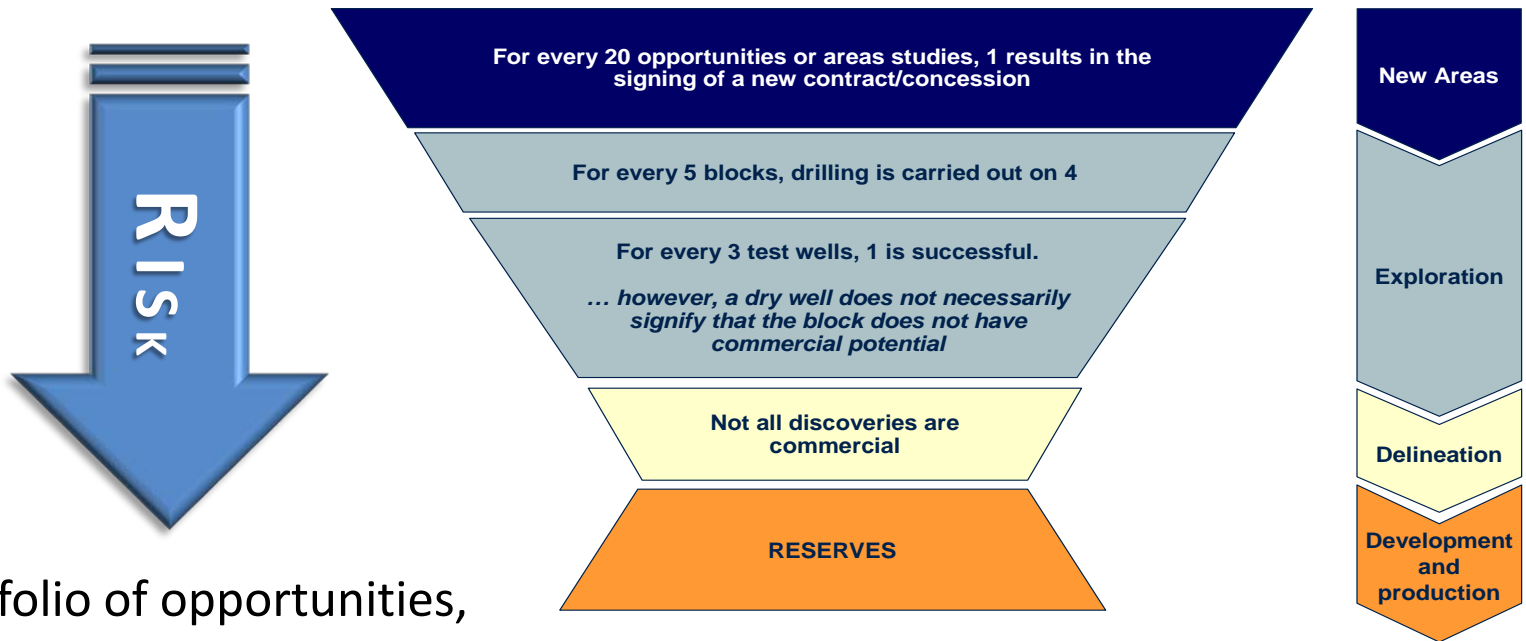
Midstream Industry

- Transportation

Extractive Industry Features

- High sensibility to commodity prices,
- Highly intensive in capital investment,
- Low level of success.

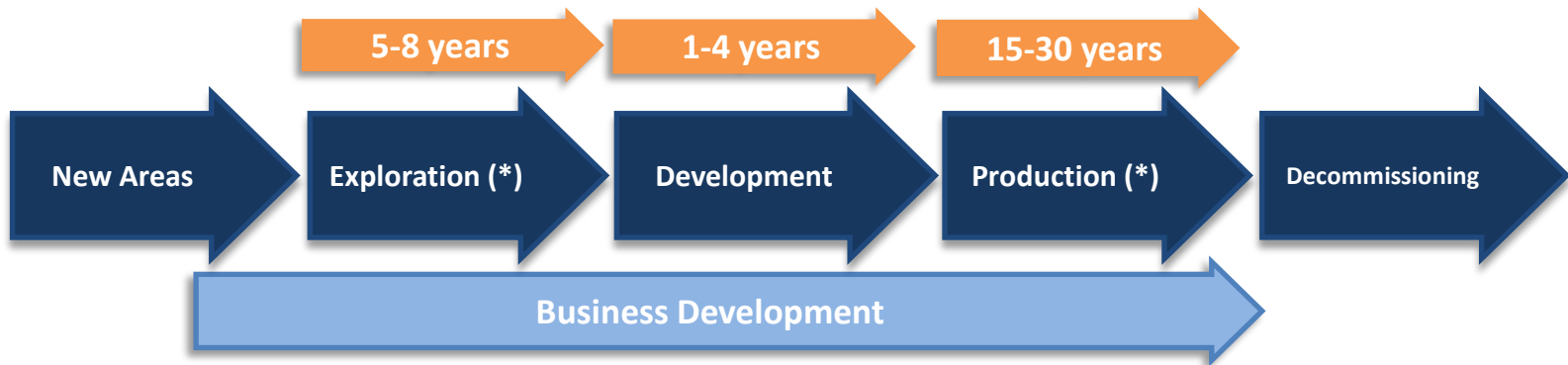
ILLUSTRATION OF THE INHERENT RISK IN THE EXPLORATION PROCESS



- Large portfolio of opportunities,
- Joint operation of projects (JOA).

E&P Life-cycle

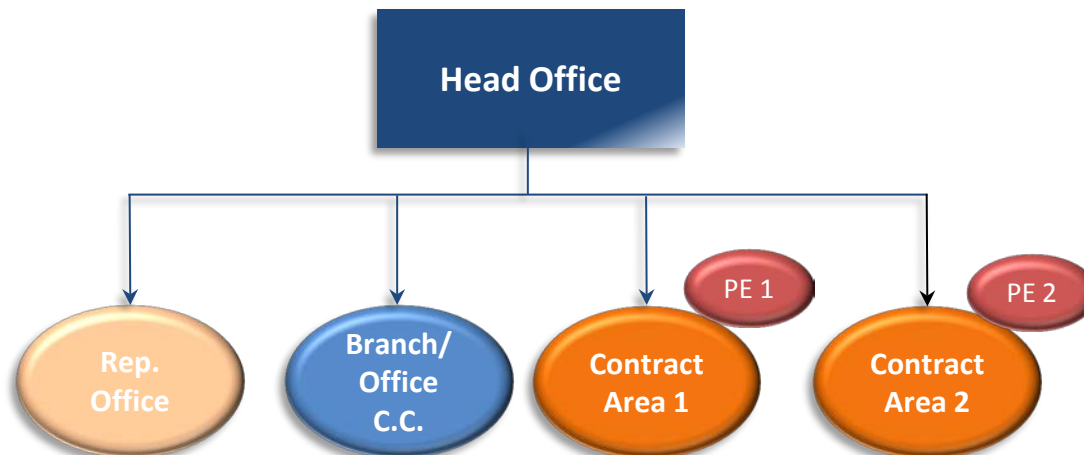
- Long-term life-cycle (30-50 years), with different temporal phases:
 - New Areas: acquisition of new mining domain to explore,
 - Exploration: identification of hydrocarbons reservoirs and its appraisal,
 - Development: construction of facilities for production,
 - Production: extraction of the hydrocarbons,
 - Decommissioning: removal of facilities or equipment from operation.



(*) Notice of abandonment: after failed exploration or dry holes (sunk costs) or wells/fields that reached “economic limit”.

PE Investment Structure

- Actors:
 - Contractors (O&G companies): license or contract holders granted by or signed with the gov.:
 - Operator: company appointed under the JOA in charge of current activities and decisions,
 - Non-operator: in the JOA the participating O&G companies, other than the operator.
 - Subcontractors: service providers hired by the contractor (e.g. drilling, casing, catering, etc.).
- Contractor's entities:
 - Representation Office: market research or other limited "non-income" generating activities,
 - Branch: mercantile registration, normally related to an office and, sometimes, to contract areas,
 - Coordination Centre: corporate functions performed by the office (place of management),
 - Contractual Area (PE): delimited area where activities are performed under a licence/ petroleum contract (block or field).



The Basic rule of PE

Test	Description	Contractor	Subcontractors
Place of Business.	Specific situs.	Contractual area.	Site.
Permanence.	Not temporary.	Long-term.	Short-term.
Right of use.	At the disposal.	Legal right.	Authorization.
Business connection.	Activity.	JOA.	Services.

- Overlapping PEs in the same situs:
 - Contractor (O&G companies): operator and non-operators.
 - Contractor and Subcontractors (subject to its own tests).
- More than one PE (Contractor): “geographical and commercial coherence”
 - Separate contracts signed per contractual area.
 - Each contractual area managed through a JOA.
 - Office/Branch (coordination centre).
 - Ring-fenced regimes (in certain countries).

E&P Different Phases (contractor)

Phase	Description	PE	No PE
Licensing new areas.	Rep Office. Joint Studies.	✓	✓
Exploration (*).	<i>"Place of extraction"</i> .	✓	X
Development.	Commercial discovery.	✓	X
Production.	Resource extraction.	✓	X
Decommissioning.	Removal of installations.	✓	✓

(*) Abandonment during the exploration phase could lead to cease of PE existence.

Construction Work (Subcontractor)

- Article 5(3) of the UN Model Convention:
 - Covers a broader range of activities than the OECD Model:
 - Includes “assembly projects” and “supervisory activities”,
 - Reduces the minimum duration to 6 months.
 - Services Permanent Establishment:
 - Furnishing of services through employees or other personnel engaged for that purpose,
 - For a period or periods aggregating more than 183 days within any 12 month period.
- Drilling Rigs or ships:
 - Expressly included in US Model, insofar they are used in E&P activities for more than 12 months.
 - Time charter (owner provides the Rig with full crew): Construction work clause.
 - Bareboat (rental of the Rig itself):
 - Art. 12 UN Model Convention: *“use of, or the right to use, ICS equipment”*.
 - Specific provisions in tax treaties: *“use of substantial equipment”* (DTT Australia-South Africa).
- Splitting up of construction contracts.
 - Between group companies to circumvent the specific 6-month time.
 - Countries can adopt measures solutions in the framework of treaty negotiations.
 - BEPS action 7: Preventing the artificial avoidance of PE status.

Off-Shore Clause

- Main Characteristics:

- Focus on offshore activities in connection with E&P activities.
- Removes traditional features of the Basic PE rule:
 - Fixed place of business,
 - Right of use test,
 - Business connection test.
- No specific geographical location required: overall off-shore area.
- Time threshold reduced to 30 days in the aggregate in any period of 12 months.

- Main Reservations on the Article:

- *“Considering the special problems in applying the provisions of the Model Convention to offshore hydrocarbon exploration and exploitation and related activities, Canada, Denmark, Ireland, Norway and the United Kingdom reserve the right to insert in a special article provisions related to such activities”.*

Withholding taxes

- Taxation: on Gross Income.
- Royalties (Art. 12 of the UN model Convention):
 - Use of, or the right to use, Industrial, Commercial or Scientific equipment.
 - Fees for Technical Fees:
 - Included in Art. 12 DTT by certain countries (e.g. Italy-Vietnam Tax treaty of 1996).
 - Managerial, technical or consultancy services.
- Fees for technical services (new Art. 16 of the UN Model Convention):
 - Managerial, technical or consultancy services.

Summary

- Wide array of applicable provisions.

	ACTORS	TESTS	PROVISIONS	GENERAL COMMENTARIES
PERMANENT ESTABLISHMENT (NET BASIS)	CONTRACTOR	Place of Business Permanence Right of Use Business connection Exceptions	Basic rule (Art.5.1) Examples (Art. 5.2) Construction Work (Art.5.3.a) Services PE (Art.5.3.b) Use of substantial equipment (Specific) Exceptions (Art. 5.4) Fixed Base (Art.14) Drilling Rigs (specific) Off-Shore Clause (alternative)	Fixed physical presence and long-term activity. In general PE exists in all phases of the life-cycle. Multiple PE exist within a country (contractual areas managed through JOA).
	SUBCONTRACTOR			In general, mobile and short-term activity. Services PE: furnishing of services through employees for more than 6 months in any 12-month period. Drilling Rigs and ships clause. Off-shore Clause. Anti-abuse provisions.
WHT (GROSS BASIS)	SUBCONTRACTOR	N/A	Royalties (Art. 12): Rental ICS equipment Fees for Technical Services Fees for Technical Services (new Art. 16)	The UN Model Convention permits the application of WHT on payments made to subcontractors in consideration for the, normally, technical nature of the services they provide.

- Countries should balance pros and cons of all mentioned provisions.
- For example, countries could:
 - Include an Off-shore Clause, or
 - Impose a WHT on cross-border payments.
- However WHT is simpler and easier to enforce, PE taxation applies to net income.
- The design of a competitive system aimed at the EI should take account of many factors, including administrative costs and its attractiveness for investments.

Thank you very much
for your attention