E/C.18/2019/CRP.11

Distr.: General
8 April 2019

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eighteenth session

New York, 23-26 April 2019
Item 3 (e) of the provisional agenda

Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries

Summary

During its last meeting in March 2019 in Vietnam, the Subcommittee on Extractive Industries Taxation Issues reviewed four of the seven new chapters to be added to the updated Handbook on selected issues for taxation of the extractive industries. The draft chapter on "tax treatment of subcontractors and service providers" was discussed and comments and suggestions received led to a new draft (annex 1) which is herewith submitted to the Committee for review comments and guidance. The discussion on the other three chapters "Tax Treatment of subcontractors and Service Providers"; "Production Sharing Agreements"; and "Tax Incentives" led to new outlines that will be presented during the 18th session for the Committee's comments and suggestion.

At the request of the Vietnamese Ministry of Finance, one-day workshop on taxation of the oil and gas industry was organized for the South-Asia subregion prior to the subcommittee's meeting. The course was well received, and the Handbook was used and distributed to participants.

I. NOTE BY THE SECRETARIAT

At the seventeenth session the co-coordinator of the Subcommittee on Extractive Industries Taxation Issues (Subcommittee), Mr. Ignatius Mvula, reported to the Committee (E/C.18/2018/CRP.18) on the work of the Subcommittee especially on the new topics to be added to the handbook for the next update. As indicated previously the new topics to be covered are the following: 1) auditing of oil, gas and mining activities; 2) tax treatment of subcontractors and service providers; 3) production sharing contracts; 4); environmental tax issues; 5) tax incentives in the extractive industry; 6) tax treatment of financial transactions (including a sub-chapter on farm in/out); and 7) trade mis-invoicing. An outline for the new chapters was presented and the Committee and other participants made comments and suggestions. For easy reference the outline presented during the seventeenth session is in the E/C.18/2018/CRP.18 attached (as Annex 7). Other than for the items addressed below, which have been the main focus of recent work, CRP.18 represents the state of the workplan on the updated handbook.

A brief meeting of the subcommittee was held in Geneva on Saturday 19 October 2018 and focused on chapters to be drafted and presented during a more substantive two-day meeting in Da Nang, Vietnam on 7 and 8 March 2019. During the Da Nang meeting, kindly hosted by the Vietnamese government and its General Department for Taxation, the Subcommittee discussed extensively three chapters namely "Tax Treatment of subcontractors and Service Providers"; "Production Sharing Agreements"; and "Tax Treatment of Financial Transaction in Extractive Industries". The outline for the chapter on "Tax Incentives" was also reviewed and commented on. A revised outline is attached (as Annex 6) to this CRP.11. The draft chapter on tax treatment of subcontractors was discussed in detail and it was agreed that a new draft would be prepared by the Subcommittee and presented for consideration by the Committee at the 18th session (as Annex 1). The chapter describes how new financial models are used in the oil and gas and the mining industries where in many cases subcontractors take on some risks. In addition, the chapter describes in detail some of the advantages of a "Subcontractor Model" for developing countries as domestic companies operating in the mining and oil industries do not need to master expertise in all aspects/areas of the industries since they can rely on external expertise through subcontractors.

The chapter also uses a series of terminologies, such as subcontractor, service provider, concessionaire, license holder, and others in the context of extractives industries and necessary harmonization with other chapters will be needed. Aspects of taxation in the extractive industries about subcontractors' arrangements, their legal status (domestic entities or foreign-resident status) are the focus of the chapter. While aspects of the Chapter are well advanced approval is sought on some aspects of that work and guidance is sought on other aspects, some parts of the paper (especially some elaborated examples) will need further drafting and "testing" in the Subcommittee before approval is sought in the Committee.

The other two chapters on "Production Sharing Agreements" and the "Tax Treatment of Financial Transactions" were also discussed at the Subcommittee Meeting in Da Nang, through detailed Power Point presentations.

The discussion on production sharing contracts (PSCs, Annex 2) centered on making the chapter more practical with several country cases to assist developing countries who may wish to use PSCs. This type of investment and financial arrangement has gained in popularity among developing countries as it allows the country to retain the ownership of its resources while involving foreign investors with the necessary knowhow and required financial capacity.

Attention in this Chapter will be paid to the balance between coverage of the oil and gas industries, where PSCs are very common, and the mining industry where they exist, but are far less common than, for example oil, Exploration and Development Agreements. Several country cases presented at the subcommittee meeting, including Russia, Vietnam, and Nigeria would serve as illustrative examples. A new outline on this chapter will be presented at the 18th session for the Committee (Annex 3) for comments and guidance to assist the drafting.

"Tax Treatment of Financial Transaction in Extractive Industries" (Annex 4) is a chapter which inevitably will have overlaps with another chapter on the same topic being prepared as part of the current updating of the UN Practical Transfer Pricing Manual. A draft of that Transfer Pricing Manual chapter is being presented for Committee consideration at the 18th Session (as E/C.18/2019/CRP.1, Attachment A) for comments and guidance to assist the drafting.

Because of the inevitable overlaps the 18th Session presentation on the Extractives Handbook chapter on Financial Transactions will seek to give only an overview and an updated outline of what is intended and how it relates to that other work (Annex 5). This chapter will seek to present the topic from an extractive industries' view point but will refer to the Transfer Pricing Manual coverage where necessary to avoid repetition and to ensure consistency. The chapter will address in greater detail than the existing Handbook topics such as "farm in and farm out" arrangements, the issue of royalties and taxation as a source of income and revenue, general hedging and commodity-hedging issues, as well as the treatment of other new financial instruments relevant to the extractive industries. Comments of Members will be sought on the broad issues at the 18th session.

Several of the proposed new areas of Subcommittee work are being reviewed to ensure they deal adequately with both oil and gas and mining aspects of the issues as appropriate. This is the case for the work on Tax Incentives in the Extractive Industries, for example, and a more elaborated outline of that chapter will be made available to the Committee (as Annex 6).

A day before the Subcommittee meeting in Da Nang, on the request of and in collaboration with the Vietnamese General Department of Taxation, a workshop on "Practical Issues, Strategies and Solutions for Taxation of the Extractive Industries" was

organized by the International Tax Cooperation Unit of the FSDO. The workshop was mainly based on the Handbook on Selected Issues for taxation of the Extractive industries by Developing Countries. The workshop was attended by Tax Officials of Vietnam, Laos, the Philippines, Myanmar, and Thailand. A printed version of the Handbook was also distributed. The workshop was very successful and indicated a need both for more such workshops on the extractive industries and more tax workshops in the region.

Annex 1:

CHAPTER XX: TAX TREATMENT OF SUBCONTRACTORS AND SERVICE PROVIDERS as a NEW CHAPTER of the Handbook Draft (as of 7 April 2019)

Contents

XX.1. Overview

XX.1.1. Scope of chapter

This chapter considers the domestic and cross-border taxation issues that arise from the use of subcontractors and other service providers (referred to as subcontractors) in the extractive sector. As mentioned in this Handbook, exploration involves great financial risks and all exploration activities do not result in success. As the extractive sector moved into remote locations and employed advanced technologies, the role of subcontractors changed. This led to specialist businesses, focused on particular activities that resource companies contract with to take advantage of their specialist knowledge, economies of scale and potential efficiency gains. In some instances, subcontractors also take financial risks by basing their return on the value of resources extracted, rather than the services provided. These specialist businesses ease entry into the market, increasing the number of potential bidders on projects and allow local companies in developing countries to pursue extractive sector projects.

The development of these expert service providers is overall a net efficiency gain. It benefits developing countries, in that such companies are better placed to support new partnerships and new operating models with e.g. national oil companies (NOCs), private sector extractive companies based in developing countries and international independent producers. By increasing the range of companies which can pursue extractive sector projects, developing countries gain by having a larger pool of potential bidders for projects beyond the "supermajors" and major mining companies, while the availability of this expertise independent of an investor approach allows national companies in developing countries to pursue extractive sector projects of their own or in partnership with foreign companies.

The taxation issues surrounding subcontractors can be complex. Some countries' tax administrations may have little experience in administering subcontractors and changes to business models provide new challenges. This means that the role and activities of subcontractors are often poorly understood. To administer subcontractors, it should be understood that:

- They only provide a defined service at a specific stage of the project. They are generally not involved throughout the extractive project, although there are exceptions. They are thus in a very different position from the concessionaire/resource company, in that they do not make an investment and derive a return based on the value of the resources extracted.
- They supply services to multiple companies, located on different extractive sites.
- They are often tax residents to different jurisdictions than the resource company they provide services to. And they are seldom tax residents of the country in which the extractive site is located.
- Their services are often performed in another jurisdiction or performed remotely in the jurisdiction of to the extractive site by using technology.
  It is also possible that while the resource company may incorporate a local entity that is tax resident in the concession jurisdiction to develop the asset, a service provider is more likely to provide the services needed from a non-resident company.

These roles and activities of subcontractors raise questions on withholding tax and/or permanent establishment (PE) treatment and the application of tax treaties. This chapter does not cover these topics in general (as is done in Chapters 2, 3, and 5), but is focused on issues specific to the tax

treatment of subcontractors. Further, the coverage is restricted to taxation issues, and other contractual issues related to service providers, such as local content, training, skill development of partner NOCs, etc. issues are not covered in the chapter.

XX.1.2. Terminology used

In this chapter:

- "Subcontractor" means a service provider to a resource company, limited to the type of services discussed in this chapter.
- "Resource company" means the concessionaire/license holder to the resource extracted.
- "Resource state" means the jurisdiction who granted the extraction license.
- "VAT" means a broad-based tax on final consumption that allows for the deduction of tax paid on inputs (referred to as GST in some jurisdictions).

XX.2. The role of subcontractors in the extractive sector

XX.2.1. Value chain in extractive sector and position of service providers/subcontractors

The upstream sector involves the search and recovery of crude oil, other hydrocarbons and minerals, as well as their commercial recovery and production. Until the 1960s, it was common practice for the oil majors to run operations completely in-house; they also conducted in-depth research into drilling, completion and production technologies. Starting from the 1980s, these were licensed to oilfield services companies, since functions such as drilling yielded low margins and diverted the attention of resource companies. During the 1990s, there was increased exploration in remote and offshore locations as well as more challenging sub-surface conditions in the extractive sector. These conditions allowed the services providers to move up the value chain to be innovators. Moving into the 21st century, accelerating commodity prices and demand, at least until the global financial crisis of 2008, created conditions where it was viable to experiment with new technologies in areas like high-pressure hydraulic fracturing, deep sea mining, etc. Major service providers had the size and scale to invest in such area and develop proprietary technology solutions.

Support operations have increasingly been outsourced to specialized companies with in-depth expertise in specific areas and the skilled personnel to deliver the work. Over time, many resource companies have increasingly become asset portfolio owners, more at arm's length from the execution of operations and support services needed to perform these. Subcontractors have established themselves as partners of the resource companies; this has affected the terms on which business is conducted, and the way tax rules apply to these parties and transactions. These partners are an integral part of the extractive sector, as can be seen from Table 1 in Chapter 2 of this Handbook.

The picture is somewhat less complex for mining businesses, which tend to keep a large part of the core business operations within their own control. There nevertheless is still substantial use of subcontractors in the industry, especially at the start of the mining project where a service provider

may be used for mine construction. And certain other services are common between hydrocarbons and minerals extraction such as logistics and at end of life/asset retirement stages.

The roles of subcontractors are broken down at XX.3 below by the resource extraction stages set out in Chapter 2.

XX.2.2. Nature of business and location of services provided

Although the subcontracting sector is dominated by a few large companies, there are thousands of small, private companies and individual contractors. Most of the companies are small in size; e.g. 94% of oilfield services companies had fewer than 100 employees in 2014. On the other hand, the top five largest publicly traded companies generated one-third of total revenue from oilfield services in 2014.

In the early stages of resource extraction (see Chapter 1), the services of these smaller businesses are predominantly performed outside of the resource state. In the latter stages, these services are predominantly performed in the resource state; however, with the introduction of new technologies, many services are increasingly being provided remotely. Most of these smaller businesses operate in multiple jurisdictions at any given time and may perform a service from multiple jurisdictions. Tax issues arising due to residency status and place of supply are unavoidable.

XX.2.3. Resident and non-resident service subcontractors

As mentioned above, some service providers operate within an environment where the sector has a large component of resident service providers (e.g. Southeast Asia). This is influenced by resource state policies for nurturing local providers and is affected heavily by contractual needs for local content. Some broader policy choices can also impact this; e.g. a centrally planned economy may put barriers to participation in the services sector by non-residents. Local company growth is driven by this protected market and resident service companies have a much larger share. The dynamics of local content rules are outside the scope of this chapter, and only their impact in terms of service provision by residents and non-residents are mentioned.

However, there are limitations to which local content rules can drive provision of services. In several developing countries, local content rules have driven the development of firms that provide e.g. staffing services, field labour, supply chain and logistics services for remote locations, warehousing and distribution services. Some firms resident in developing countries have also developed competences in niche engineering and maintenance services. However, projects in most developing countries must retain expertise from non-resident companies in order to meet all the complex expertise needs in modern extractive projects. This is particularly true in the case of proprietary technologies developed by large and specialist service providers; these companies have the size, expertise and capital to invest in the R&D necessary for such technology. Developing countries will thus have to consider the need to deal with tax issues arising from payments for services acquired from non-residents.

XX.2.4. Subcontractors related to resource companies

Subcontractors can either be under control of a resource company (partially or wholly) or be independent of the resource company. If under control of the resource company, issues relating to affiliates may arise (see Chapter 5 and the UN Transfer Pricing Manual). This chapter is relevant for subcontractors under the control of a resource company, but additional guidance should be sought on the application of the arm's length principle (Chapter 5) and Art 12(6) and 12A (7) of the UN Model Convention 2017 (UNMC), provided in the Commentary to the UNMC. Specifically…

Subcontractors who are not under the control of the resource company, may nevertheless be involved in the functions, assets, and risks of a project. As the hydrocarbons sector becomes more capital intensive and exploration risks increase, e.g. in remote fields, oilfield services companies can be pushed to take on more of the project risk. While the distinction between resource companies and service providers remain, there are examples of hybrid operating models where the service provider takes on some of the project risks. Such hybrid operating models results in the subcontractor realising returns over a longer term, "life-of-field or mine" basis. Subcontractors and resource companies can also jointly own intellectual property that each party exploit in a different manner. The tax issues arising from these hybrid operating models are considered in this chapter.

Transparency in transactions in such complex cases, especially with regard to the arrangements with subcontractors, should be considered an essential part of tax regime design for the extractive sector. Developing country tax administrations should consider arrangements for parties to such complex cases to make a voluntary disclosure of the transactions involved. This will enable tax administrations to satisfy themselves about the accurate tax treatment of the cashflows involved and provide certainty to taxpayers.

XX.3. Subcontractor services by stage of extractive activity

XX.3.1. Contract development stage

Resource companies tend to control and manage this stage directly, both for business confidentiality reasons and for efficiencies in business strategy. A resource company may retain advisory firms for negotiations and external consulting and research firms to evaluate the project. Most of these service providers will not be residents in the resource state. To the extent that they are, that tax consequences should not differ to another sector. E.g. any consideration paid to providers would be subject to the tax rules of residence state of the resource company, unless of course the resource company has incorporated a local company for the purposes of the bid.

One area at this stage that may present some tax policy and administration challenges in the resource state is where local partners in the resource state have been compensated in cash or, in a more complex circumstance, out of a future share of the returns from the resource project. This is usually a business development partner, who provides services in securing the concession. In the first circumstance, where an explicit fee for the service is charged, there may be challenges around reporting the fee and applying withholding tax. In the latter case, where the compensation is economically a capital investment the local partner has made in, there is a question of timing, i.e.

when the service provider has actually earned the consideration, and treatment of income that arises where the project starts to generate revenue.

XX.3.2. Exploration stage

Exploration processes in the extractives sector require specialized technical skills which are not typically retained by the resource company. This phase involves geological, geophysical, and geochemical analysis using sophisticated software and technologies, such as advanced 3D seismic technology. Subcontractors often conduct geological mapping and surveys, seismic capture and sampling, analysis, test drilling or excavation services, etc. The resource company may also outsource local staffing, logistics support and other ancillary services.

Other resource companies may have some in-house capabilities for this phase or may have related group service companies that have special competencies in these areas.

The tax issues in this stage are likely to be around characterization of the payments. Where services are performed, and payment is made may differ; some services will be performed outside the resource state and payment will be from the resource state.

XX.3.3 Feasibility and design stage

To evaluate whether the project should commence, subcontractors provide economic and technical analysis, mine planning, design of exploitation platforms, etc. Again, a significant part of the services would necessarily be performed outside the resource state, while consideration paid would have to come from the resource company.

XX.3.4. Development

Production drilling, mine construction and building of the necessary facilities can be conducted onshore or offshore. Typical services include the engineering and construction of platforms, conveyer lines, pipelines, and storage tanks. Mining companies are likely to retain service providers for a large part of the construction and upstream companies may appoint oilfield services companies.

XX.3.5. Production and distribution

Subcontractor services assist in production support, pipelines and transportation, and byproduct processing. Other services assist with secondary oil recovery using specialized technologies and the management of production operations.

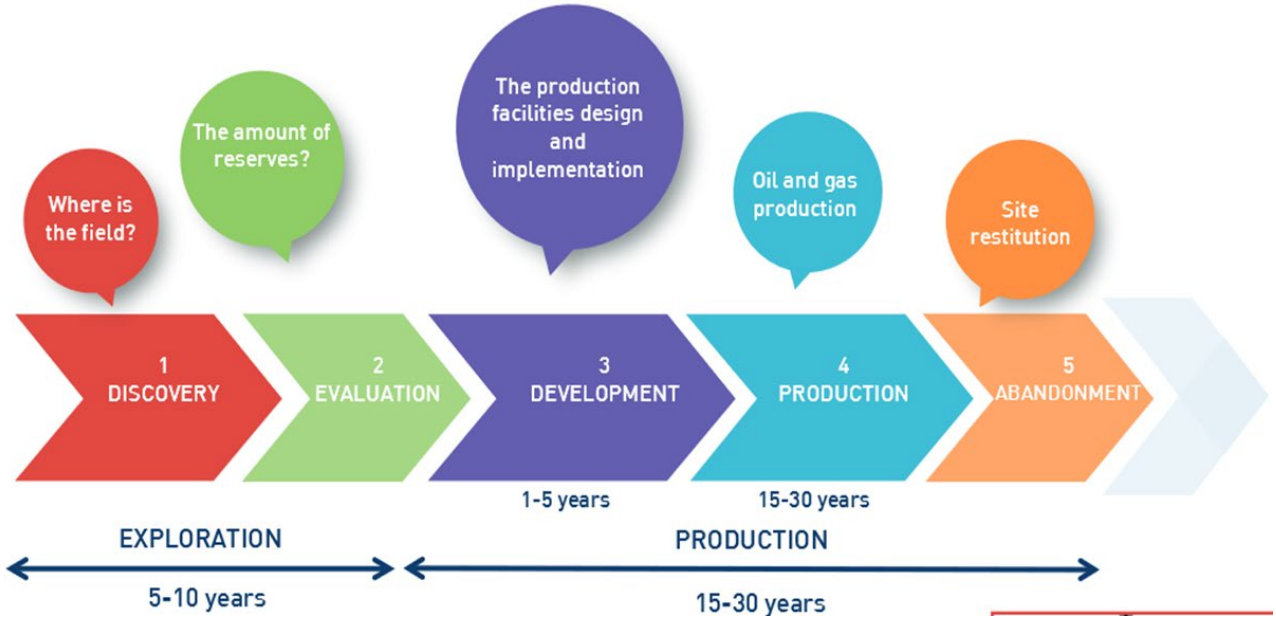
XX.3.6. Ancillary

These services will include aviation (for offshore platforms), logistics, catering for exploration and production sites, tugging, anchor handling, hookup operations, firefighting, standby services, health and safety, etc. They can also include related services that need to be completed as a part of

the project, such as the construction of new roads for removal of minerals extracted and relocation of habitats which can have alternative uses unconnected with resource extraction.

XX.3.7. Shutdowns

Services at end of life phase of a project will include decommissioning and maintenance of abandoned sites, e.g. removal of structures and restoration of land surface for mines. Service providers in this category tend to be specialized and may not have had any involvement with the project before this stage.



XX.4. Special challenges in service provider/subcontractor tax issues

XX.4.1. Main tax issues for consideration

Sub-contractors are essentially service providers to resource companies and are engaged by resource companies for a variety of reasons including obtaining specialised expertise and providing significant additional resources during periods of major expansion and rehabilitation. In the context of developing countries, the gross revenues earned by service providers and subcontractors in the resource state are substantial and a large proportion of the capital investment made by a resource company. It is therefore appropriate that the resource state taxes these flows using direct and indirect taxes. As a matter of general approach, the object should be the taxation of profits in the jurisdiction of the resource state, rather than of gross income. Subcontractors should also be held responsible for compliance with indirect tax rules related to their transactions. In principle, such companies should only be taxed on their profits in the jurisdiction of the resource state and on goods and services supplied and consumed in the resource state. In practice, however,

it is difficult for many countries to track and identify income flows and rather rely on withholding taxes on gross income.
The primary tax issues are:

- Identification of relevant income that should be subject to tax in the resource state – for example 'on-shore income' or 'off-shore income' based on source rules
- Characterisation of the relevant income that may be relevant for income tax and WHT purposes – e.g. 'royalties', 'technical services', 'construction' and 'supervisory activities, and in some cases whether services are performed on-shore or off-shore services. The application of income taxes to the relevant income (by way of corporate income tax and/or withholding taxes)
- PE application for the subcontractor
- VAT issues
- Customs duty on imported goods as well as inputs
- Employment withholding taxes on staff payroll and whether this applies to subcontractors, and
- Government fees, levies (e.g. a training levy) and licencing costs.

Special challenges relate not only to substantive taxation issues but also to a large extent to administrative issues for example getting basic information about which players at the subcontracting level are actually performing services and on what contractual and factual basis. Reporting obligations and mechanisms are important in order to establish facts. Countries should therefore place equal importance in establishing accurate reporting systems that help the tax administration identify the components of a transaction, and the underlying facts to help guide analysis and administer taxes in an efficient and transparent manner. In addition, tax administrations may consider providing administrative guidance to taxpayers in relation to how they intend to interpret the relevant domestic and international tax rules using relevant examples and case studies.

Some more complex tax technical issues arise in respect of subcontractors in the extractives sector due to the substantial size, technical complexity and number of parties involved in extractive projects. Three particular issues are described below under separate subsections; these are not unique to the extractives sector and may be present in infrastructure project contracts, large foreign direct investment projects, etc.

Subsequent sections of this chapter discuss each of these issues in turn to help both developing country tax administrations and taxpayers determine the tax treatment of transactions. This clarification benefits not only the businesses involved, but also, by providing clarity and certainty for business also helps the overall investment environment.

XX.4.2. Tax policy approach for subcontractors

An initial question that countries may wish to consider is their substantive approach in direct taxation of subcontractors in the extractive sector. The policy instrument of choice, as seen above, is to tax income flows on a gross basis through a withholding tax mechanism. While such a WHT led approach is easy to administer, this ease comes at a cost. In many commercial contracts, sub-contractors simply pass on the WHT cost using "gross up" clauses so that the resource company's overall cost increases to take account of WHT. Where the resource state has an equity interest in the resource project and in cost sharing contractual arrangements for developing extractive

resources, where the resource state is liable for a share of the costs of development, these taxes then become an additional cost which the resource state effectively pays itself when the project starts commercial production. The tax revenue to the resource state is thus largely a timing gain; there is a limited benefit to the resource state to the extent that the resource company bears tax on its share of the cost outlay, as well as a security of payment in cases where the eventual payment of tax might otherwise be doubted.

However, that gain should be considered against the potential disincentive towards investment in resource extraction posed by both the revenue and the compliance costs of administering the WHT regime. The Introduction to the UN Model notes that: "to the extent that [withholding taxes] taxes levied in the State of source exceed the amount of tax normally levied on profits in the State of residence, they may have a detrimental effect on cross-border trade and investment."[1] Countries should therefore consider establishing procedures through which they can make a cost benefit analysis of WHT treatment versus the effort of seeking to establish a PE of a service provider, and should in any case seek to have withholding tax rates reflecting likely profits. This analysis may include consideration of the rates of WHT applicable under domestic law or relevant treaties. Whilst a modest level rate WHT is a useful compliance tool, unrealistically high or uncompetitive rates of WHT may deter investors. Where the resource country does not have a network of tax treaties that apply to reduce WHT rates, resource countries may consider a reduction in domestic WHT rates for certain activities, as some investors may see high WHT rates as prohibitive to investment.

XX.4.3. Outline of case studies used.

This chapter uses case studies to identify the tax issues by subject area. *These cases have been tested through engagement with tax administrations and companies in the services sector.* This section outlines the facts of the cases. A typical project will involve several companies that will be tax resident in a variety of jurisdictions distinct from the residence state of the resource company. The types of transactions discussed in the case studies will require analysis for one or more of the tax types mentioned in XX.4.1. and are covered in detail in XX.5., et. seq.

Contract I – Seismic data capture and analysis

Company Y, a special purpose entity formed in Country A (resource state) contracts with Company P, a specialist firm tax resident in Country D to provide seismic data capture and analysis in an offshore block where Company Y is the concessionaire. All services and works necessary in connection with acquisition of offshore seismic data shall be executed by P. P possesses all the necessary expertise, or the ability to find additional subcontractors to perform necessary components of the service, diligently in accordance with current standards and practices of the industry and subject to the provisions of the contract documents. The contract requires that P shall, at its cost and expense, furnish supervision, manpower, equipment, materials and supplies necessary for the performance of the service in a diligent manner.

The seismic data is captured primarily through a vessel that enters the external economic zone (EEZ) of Country A. However, some of the seismic data capture process includes aircraft-based

[1] At paragraph 15.4.

equipment; the aircraft in question is based in neighbouring Country B and does not land in Country A; it merely flies over the EEZ to capture the data. The data is then sent to Company Q, which is tax resident in Country E for the analysis work.

In consideration of the payment to be made by Y to P, P covenants to perform and complete the service in conformity in all respects with the provisions of the contract. Y will to pay P in consideration of the performance of the service the compensations at the time(s) and in the manner prescribed by the contract. All contract rates of compensation and any other price(s) agreed upon by the parties include any charges and provisions necessary for the total completion of the service covered by the contract and deemed to cover all expenses and dues including taxes borne, or to be borne, by P together with all responsibilities that P has undertaken and any consequence deriving therefrom.

Contract II – Turbo Drilling Services

Turbo drilling services are required to drill the very hard basement formations in the deep gas wells in a remote location in Country A. The work scope is defined as the provision of adequate turbo drilling equipment and competent field personnel to supervise the operation of the equipment and to facilitate the performance turbo drilling in the specified oil field. The work scope is limited to provision of said equipment and personnel to one drilling rig in relation to either directional or straight hole turbo drilling operations.

The vendor, Company P tax resident in Country B needs to provide turbines suitable for drilling the hole section in the deep gas wells and to provide all the required accessories for the required hole size with adequate maintenance schedules. P must also provide qualified engineers and engineering services at the field for running the turbines, and is responsible for importing the turbines to Country, transporting them to the remote site, and be operational by the date set in the contract. P contracts with Company Q resident in Country A to provide the logistics services.

Contract III – Sale of goods (drill bits) and associated services

Company P tax resident in Country A will supply to the Company X resident in Country B (resource state) various sizes of drill bits, as and when requested by the Client. The goods to be supplied and any related services will be for an initial term of two years and any subsequent optional periods at the Client's discretion. Sourcing options include direct purchase (consignment arrangements), compensation by a rental cost per foot or performance-based incentives.

The scope of work includes the provision of certain associated services onshore such as the provision of technical support and personnel as required, prior to the mobilisation of the goods, and to assist the Client during the performance of drilling related operations by the provision of technical advice pertaining to the supply and performance of the goods provided under the terms of the agreement. The Seller shall comply with the specifications for the goods as contained in the scope of work and included in each client-issued related purchase order.

The Service Agreement would become effective from the Effective Date and be valid for an initial period of two years. The Client has the option to extend the agreement for two further periods of one year each on the same terms and conditions by giving notice of thirty days. Quantities of goods are to be detailed in the Client purchase orders in line with an indicative quantity of goods. The Seller undertakes to provide drill bits and engineering services to optimize bit selection and performance and conform to the Client's industry standards and specifications. The supply of goods includes but is not limited to drill bits; drill bit and BHA design engineering service; and post-run bit evaluation and Final Bit Report for Well with recommendations for future wells.

At the end of each well, the Seller's in-country service representative can visit the Client's yard in Country C or the offshore rig, as appropriate, to inspect the goods used on a particular well. Following inspection, the Seller will compile a service report including pictures of the bits used covering their applicability, performance, and any recommendations for improvements in performance or bit selection. The report shall be submitted to the Client's drilling engineers within one month of the completion of the well.

The Seller will provide all necessary onshore technical support during the term of the agreement, at no additional cost to the Client, which will include a Supervisor available to the Client for discussion of all technical queries pertaining to the goods provided. The Seller's technical support will assist the Client's drilling engineer in drill bit selection and BHA optimization using computer simulation and design programs to maximise drill bit selection and BHA optimization.

Contract IV – Well Service Contract

Company P tax resident in Country B agrees to Company X resident in Country B (resource state) various services related to the maintenance of an offshore oil platform. The work performed by P includes service requirements for oil wells in the detail specifications described in the contract. P should prepare and submit the necessary detailed technical reports and other documentation as described in the contract.

The contractor should maintain a comprehensive inventory of equipment, spare parts and tools required to successfully perform the work on a 24-hour basis or other hourly basis, as requested, with minimal interruptions for maintenance or repair. The contractor shall clearly state terms and conditions for inspection and repair of the contractor's equipment upon demobilization. The contractor's personnel shall inspect, assemble and make ready to operate the contractor's equipment immediately upon arrival at the work site.

Contract V – Equipment Leasing

Having agreed to enter a contract in the territory of Country A (resource state) the contractor shall agree to supply equipment on the terms and conditions and at the price specified in the contract. The price list of equipment shall remain fixed and firm for the duration of the contract. The contractor will consign all the equipment. The monthly rental shall be payable per calendar month only for the minimum quantity of equipment on retainer if it is fully serviceable. No monthly

charges shall be paid for any additional serviceable quantity of equipment the company has in its inventory.

Daily rental rates shall apply from the date the equipment is required on a company site as per the hire notice and shall cease when a site off hire notice is issued by a site representative. The daily rental shall be additional to the monthly rental. The rental rates (both monthly and daily) quoted by the contractor include routine servicing, testing, inspection, normal wear and tear and supply of normal related items. A charge showing the maximum running hours for each piece of equipment and the actual hours as at the date the equipment arrives at the company's area basses shall be supplied with the equipment.
The contractor shall provide an equipment identification card (route card) with the equipment. The card will accompany the equipment despatched to the rig site to enable the responsible staff to log in actual data such as equipment identifications number, specifications, actual and maximum running hours and proof of purchase with acquisition date.

All inspection will be performed by a company approved subcontractor at the company's area bases at the company's cost. All repair charges for equipment shall be pro-rated based on the actual running hours compared to the manufacturer recommended running hours between service with a maximum charge of 100% if reaching or extending beyond the recommended running hours.

The contractor shall promptly mobilise and maintain the agreed maximum quantity of equipment. The contractor shall consign and maintain at their responsibility and cost adequate quantity (stock) of spares for all types and sizes of equipment for the company's base operations to allow for timely repair of the equipment. Timely replenishment of all requested consigned spares will be provided by the contractor at their responsibility and cost. The contractor will be held responsible to investigate any failure or abnormal damage to the equipment requested by the company, on a case by case basis, and the contractor shall promptly report in detail to the company.

Contract VI – Provision of drilling services utilizing a MODU

Company P, resident in Country B agrees to provide a MODU (Mobile Offshore Drilling Unit) to Company X and Company X, both incorporated as single purpose entities in Country A (resource state), engaged in the exploration phase in contiguous offshore blocks in Country A. Company X and Company Y are respectively owned by separate IOCs without any cross ownership. The value of the MODU is estimated as $ 150 million, and the daily charter rate is agreed to be $ 600,000. In order to reduce downtime during the travel from Country B to Country A, it is agreed that the drilling activity will be performed consecutively at Company Y and Company Z blocks, and the two client companies will share equally the charter costs during mobilization (travel to Country A) and demobilization (travel back from Country A).

XX.4.4. Complex tax issues: Split contracts

The first challenging area is the need to address mismatches and challenges around split contracts. These are more likely to be encountered in the initial stages of the life cycle of extractives projects, i.e. up to XX3.3. above. Contracts for services to be provided might be split up into an onshore (i.e. within the resource state) and an offshore component (outside the resource state). There can

be good reasons for doing so as discussed above, e.g. the skills and expertise may simply not be present in the resource state and it is neither cost-effective nor practicable to bring them there.

However, there is often mistrust on the part of tax authorities in the resource state regarding the relative pricing of the services being provided offshore and onshore, and the timing thereof. To the extent that the resource state relies on the approach outlined in the UN Model Convention 2017 (UNMC) and its Commentary, and the payments made arise in the resource state, and the treaty partner accepts that approach, the entire consideration for the split contract would be deemed to be sourced in the resource state. However, where the treaty partner does not apply the same approach, split contracts essentially become a transfer pricing issue to the extent that the service provider or its related parties (within the meaning of the domestic transfer pricing legislation) are providing the services themselves. The application of the arm's-length standard should satisfy those concerns, but it may be necessary to have detailed descriptions of the services as comparable prices for these services might not be publicly available. Where, on the other hand, the services are provided by genuine third parties, there should not be a concern as both the service provider and its client (the resource company), would have an incentive to ensure that the price was appropriate. Development of good internal guidance on timing of revenues will be an important part of the solution to these issues.

XX.4.5. Complex tax issues: EPC and long-term contracts

The second challenge is around consideration for larger, long term EPC contracts, typically at the development and abandonment stages of a project. Given the size and scale of such tasks an EPCM contractor assists the resource company manage the entire project, under a Progressive Lump Sum (PLS) contract. The remuneration, i.e. the contract price, is awarded on an estimated lump sum basis, but the entire project contract is broken down into several sequential contracts. The project is managed by the resource company which bears the entire cost risks. However, the contract stages are awarded to the contractor in sequence, and after completion of every stage or milestone, the contract price for the next stage is renegotiated, so that the overall contract price for the project is progressively adjusted for variations and changes in scope. This is done to ensure flexibility for project development and to ensure that contracted values reflect market conditions as actual costs are incurred. E.g. the price of steel, which is prone to significant fluctuations, is a large component in an offshore hydrocarbon platform; contracts must be flexible to reflect that reality and ensure that the project gets completed on time. The contract price is thus progressively converted from a target price into an actual contractual liability.

However, a tax administration might be unfamiliar with this type of complex contracting vehicle, and there may be legitimate concerns that the resource company and the service provider are manipulating contract values. As these are often significant sums, the consideration paid will also impact the cost recovery mechanisms in a PSC structure (see chapter XX) and contract variations will impact withholding taxes paid to subcontractors and other service providers, as well as the payments from the resource company to the main service provider. Tax administrations should therefore develop some expertise in monitoring such longer-term contracts and familiarize themselves on the timing points to ensure that the right amount of tax (WHT, VAT/GST) is paid at the right time. Development of administrative regulations on long term and milestone-based contract vehicles would help tax officials in the field address these issues. Such guidance would

necessarily extend beyond service providers in the extractive sector and could cover construction and project management businesses.

XX.4.6. Complex tax issues: Use of proprietary technology and intangibles

The third area worth considering are challenges from new technological developments including the increased use of intangibles in the provision of services. E.g. it is now possible to manage some offshore platforms on a purely unmanned basis, using remote management centres and by use of information and communication technologies (ICT). It is conceivable that a resource company may operate such an offshore concession through a completely outsourced operational model, using proprietary technology owned by the service provider, or jointly owned intellectual property. This point was considered during the deliberations on the commentary to Art. 12A UNMC, where the majority view was to resolve the issue by application of source taxation to the entire consideration; however, the minority view seems inclined to take a more "classical" approach of seeking to attach liability based on services actually performed in the resource state. Mining examples/cases to be done. Contract mining and bring in mining engineering companies.

There are wider interpretative issues in dealing with questions that these new technological developments pose. Tax administrations should seek to develop a general approach in dealing with these outsourced models, informed by the requirements of domestic law and interpretive guidance from the United Nations work on transfer pricing and "digitalization of the economy". Such administrative guidance should be broad and provide some distinct approaches without being prescriptive, as each project will have unique features born out of the contractual issues related to the project.

XX.4.7. Tax treatment of depreciation

A separate issue relates to deductions for depreciation in the case of a taxpayer that has been deemed to have a PE and is subject to taxation on a net basis rather than a withholding tax on gross income. In such cases, the equipment in question is owned by the service provider and is temporarily deployed in the resource state. As such equipment is typically high in value, their use can be highly intensive, and use in adverse conditions in remote or offshore locations can result in depreciation beyond normal rates allowed for in domestic tax legislation. Also, domestic rules may not actually allow deductibility of depreciation, especially where specific equipment is only used for a limited period within the resource state. This is an important issue, as typically the true depreciation cost of equipment will be built into the consideration due for the services provided.

The opposite situation may also apply; equipment reaches the end of its useful life during a particular deployment in a resource state, and it is not worthwhile to pay for it to be transported to the head office location. The question is then whether the difference between the depreciated value at the date of entry into the resource state and the realized scrap or sale value can be deductible in the resource state, when it is likely that much of the actual depreciation has occurred in other jurisdictions.

Key factors in establishing accurate depreciation treatment, which countries should consider in designing administrative principles for taxation of subcontractors and service providers, are:

- Reasonably accurate valuation for tax purposes of movable assets that are transferred into and out of a taxing jurisdiction.
- Treatment of Customs Duty and VAT/GST on import, especially where equipment is scrapped or sold.
- Establishing approximately accurate depreciation schedules for specialised equipment used in extractive exploration and production, which might not be included in the standard depreciation schedules contained in the income tax law.

XX.4.8. Tax issues arising from consideration for unused/stored equipment.

These issues can come up in connection with arrangements where a non-resident subcontractor keeps vessels, equipment and staff stand-by in its residence state or in a third location and are paid "standby" fees for this. Where the same subcontractor has a PE in the resource state an immediate question is whether these fees should be attributed to the PE. Countries should consider this aspect in determining guidelines for the taxation of service providers and subcontractors. Such an approach should of course start from the general rules for allocating income to a PE in the resource state's treaty policy; however, it would be appropriate to also consider establishing specific rules for this area.

If the service provider can demonstrate that the standby service is completely unconnected with the functions carried out by the PE, there is strong case for the income not to be so allocated. This is on the basis that it falls out of the provisions of Art. 7(1)(c) of the UNMC "other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment." E.g. if there is a "site" PE established to providing specific maintenance services to an onshore site of the resource state's NOC, and the standby fee is paid by an unconnected IOC for having emergency firefighting services on standby for that IOC's offshore platform in the resource state, there is a case that the income should not be allocated to the PE.

A second issue is the characterization of the income for WHT purposes where it is determined that the consideration cannot be allocated to a PE. As the consideration paid is for accessing business services and equipment, it would clearly be outside the definition of dividends or interest. Assuming the relevant treaty defined royalties in the relevant article using language from Art 12(3) UNMC) "…...or for the use of, or the right to use, industrial, commercial or scientific equipment", it would seem possible to treat the payment as royalties subject to WHT. This would be especially be the case if the consideration paid covered both the right to use the equipment and related services.

If, however, the associated services of personnel on standby were compensated separately, it would be necessary to consider if the payments for standby fell within the ambit of technical service fees or royalties under the relevant treaty. In the absence of a treaty, a general withholding requirement on payments to non-residents might be applicable. Where, however, these conditions are not satisfied, and the income cannot be allocated to a PE, the consideration would need to be treated as business income, for which taxing rights are allocated under the business profits article of the relevant treaty (Art. 7 UNMC).

XX.4.9. Payments for services delivered in special economic zones or special areas

Should this include bonded areas for consumables?

XX.4.10. Payments for services rendered by affiliates of service providers and subcontractors.

The starting point for the tax treatment of these payments is of course the transfer pricing rules of the resource state, and to ensure that the arm's length standard is applied in such cases. Reference should be made to the guidance in the United Nations Practical Manual on Transfer Pricing, particularly the treatment of Intra Group Services and Cost Contribution Arrangements in chapters B.4 and B.6 respectively. The latter could be of particular interest, as multiple affiliates of the larger service providers could enter into such arrangements for development of technology that is used by each of the affiliates in their own contracts. In addition this could include several intragroup centralized services relating to management shared cost, captive insurance , in house financing, factoring , procurement, warehousing logistics and other services

The Commentary to the UNMC, at Para 26 describes the alternative provision for Art. 12A of the UNMC, which allocates a source taxing right without physical presence if services performed by closely related enterprises. The alternative provision gives a detailed definition of related parties for the purposes of this exercise. While this may not expressly be provided in an applicable treaty, tax administrations may consider using these criteria for determining closely related parties, after due regard to their own transfer pricing rules.

Payments by a resource company to its own affiliates that provide technical services are dealt with in Chapter 6 of this Handbook.

XX.5. Characterization of income and withholding tax issues in domestic law and tax treaties

XX.5.1. Charge to withholding taxes

Withholding taxes are the most common approach in taxing payments made to service providers and subcontractors. The characterization of income under domestic law and treaty practices in resource states will govern this treatment; while typically the charge to withholding tax will be quite broad, it is unlikely that the larger service providers and most subcontractors of significant size will structure their arrangements without some degree of treaty protection.

However, smaller non-resident subcontractors who operate specialist service businesses may often be located in non-treaty jurisdictions; these, and of course domestic subcontractors in the resource state, will be subject to withholding under domestic law. Tax administrations in resource states should therefore consider a compliance approach that looks carefully at especially the smaller subcontractors and set up tests that will require them to prove their residence status and do so for each successive tax year. Closer examination may show, e.g. that the specialist with a UK passport who performs diving services and gets paid to a UK bank account actually operates through a one-man service company based in the Isle of Man! For most other entities, the charge to WHT will

be impacted by the characterization of the income in question, and how taxing powers for that income are allocated in the relevant treaty, see further below.

The charge to WHT on income flows of services providers and subcontractors, as moderated by an applicable treaty, will be heavily influenced by whether the treaty is based on, and more importantly, interpreted in line with the UNMC and its Commentary. Unlike the OECD Model, the UNMC deems
royalties and technical service fees "to arise in a Contracting State when the payer is a resident of that State", at Art. 12(5)/12A (5) UNMC. This is further extended to such payments by the PE of a non-resident where the obligation to make such payments is incurred in connection with the activities of the PE. It is of course later clarified that Art. 12/12A would not apply where the income is attributable to the PE of a non-resident (where Arts. 5 and 7 would apply); see further XX.6 below.

Detailed guidance on the scope of the charge is available in the Commentary to the UNMC; Para 13 of the commentary on Art. 12A is of particular importance here, which clarifies that the scope of the charge contemplated is wider than the services delivered performed in the resource state. The opposite view is also discussed in Para 16 of the same discussion, where the minority view was to rely on a taxing nexus based on the extent of services actually performed in the resource state. Accordingly, there are likely to be disputes on allocation of taxing rights in split contracts even where the relevant treaty allocated taxing rights to the resource state through definitions based on Arts. 12/12A (5) UNMC.

Where the relevant treaty has a more restrictive definition of royalties, lease payments and technical service fees, WHT treatment becomes more challenging. Some typical problem areas are around distinguishing service fees from lease payments (e.g. where a single payment is agreed for rental of equipment with associated services, and the treaty only covers lease payments), service contracts associated with sales of goods, etc. In the absence of a charge to WHT, the income should be considered business income and the next issue is then to see if the income arises through a PE, see XX.6.

Example Contract I: Withholding tax

Payment for the seismic survey services would typically be subject to withholding tax under domestic tax law of country A if company P's income is not taxable as a permanent establishment (see below under XX.6). These withholding tax rates are set out in the national tax law and could include withholding tax on technical services.

The domestic withholding tax rates are modified by the tax treaty between Country A and Country D, which places a maximum percentage on the amount of tax that can be withheld by Country A on royalties and technical service fees. Assuming here that the definition of technical service fees in the applicable tax treaty in line with the UNMC, and Country D is willing to accept the more expansive analysis of a pure source-based approach, the entire services covered by the contract are within the definition of services liable to withholding tax.

XX.5.2. Characterization of income for the purposes of WHT charge

The discussion above shows that the charge to WHT, imposed by domestic law and moderated by an applicable treaty, will be significantly impacted by the language of the treaty and its interpretation. This will of course crucially depend on the degree to which the resource state has been able to achieve a broad enough definition in the royalties article, or even whether there is a technical service fees article (as is the case in some treaties). A treaty which defined royalties using language from Art 12(3) at the UN Model Convention 2017 (UNMC) "…..or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience." rather than the more restrictive language of the OECD Model Convention, would of course be more advantageous from the point of view of the resource state. A treaty that covered payments for technical services, especially those based on Art. 12A UNMC that allocated taxing rights to the source state on such income would give the resource state scope to charge WHT on the payments.

The practical reality is that most treaties are based on compromises reached between the treaty partners, and most current treaties will not use the language of Art. 12A UNMC. The key issue is thus characterization of payment flows to service providers and subcontractors as royalties or technical service fees subject to the allocation of tax rights through WHT in the treaty. The question is whether the payments are covered by the "…… for information concerning industrial, commercial or scientific experience" definition in the equivalent of UNMC Art 12(3) in the treaty, assuming that such language does exist. Alternatively, where a technical service fees article does exist, it would be necessary to determine if the payment constituted such fees.

The commentary on this point at Para 12 of the UNMC Commentary cites Paras 8 through 18 of the OECD Model Commentary; Para 11.3 - 11.6 are of particular relevance on the Art. 12 interpretation. The OECD Model Commentary makes here a distinction between know-how and services provided, with the latter being considered a more applied exercise involving personnel, capital investments and management of subcontractors. It is useful to note that the OECD Commentary also includes services delivered electronically within the scope of services covered by the expression "…… for information concerning industrial, commercial or scientific experience". This indicates that the OECD approach also envisages that fees for some remote services could be characterized as royalties and therefore subject to WHT.

The UNMC Commentary on Art. 12A (for which there is no OECD equivalent) provides significant guidance on application of technical service fees and elaborates the distinction between know how fees and fees for actual services at Para 60 et. seq. of the commentary to Art. 12A. It also addresses in detail areas such as the treatment of reimbursable expenses paid to a service provider and addresses some key definition issues such as payments by individuals for services for personal use (excluded under UNMC Art. 12(3)(c)) and the potential inclusion of income from international shipping or air transport. It is not proposed to repeat that guidance here, but to note it will assist in characterization of income flows as royalties and technical service fees for the purposes of the application of WHT under the relevant treaty.

A key point of the guidance available is at Para 85 of the commentary to Art. 12A, which states that while there are, in theory, differences between technical service fees and royalties, in practice

this is quite difficult to distinguish. Also, as most treaties currently in force would have been negotiated before the inclusion of Art. 12A into the UNMC, it is likely that the only treaty provision available will be that equivalent to Art. 12. It will therefore be necessary to have a pragmatic approach in income characterization, based first on the domestic law of the resource state and then applicable treaty provisions, with reference to the UNMC Commentary. Countries may wish to take an approach under which the UNMC Commentary on Art. 12A is considered separately where the relevant treaty has an article covering technical service fees. Where it does not, the guidance in the commentary on UNMC Art. 12 is used, of course where the relevant language of "…… for information concerning industrial, commercial or scientific experience".

A further compromise approach could be that of adopting the narrower interpretation of technical service fees discussed at Art. 24 of the commentary to UNMC Art. 12A. This would allow taxation by resource state (from which the payment is made) in cases where the services are not performed in the resource state; however, the fees must be for services that are directly related to the enjoyment of property for which a royalty as defined in the equivalent to Art. 12 is paid. This would of course limit the ability of a resource state to apply WHT only to services associated with intellectual property.

Contract II: Withholding tax

Payment for the services performed in ?? could be subject to withholding tax under domestic tax law if the company's income is not taxed as a permanent establishment in??.
The domestic withholding tax rates are often modified by tax treaties which could place a maximum percentage on the amount of tax that can be withheld by the source state on royalties and technical service fees. The article of the US India tax treaty dealing with royalties and fees for included services restricts withholding tax to a maximum of 15%.

Under the provisions of the treaty "fees for included services" are payments for rendering any technical or consultancy services (including through the provision of services of technical or other personnel) if such services: (a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which the payment is received; or (b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

Contract III: Withholding Tax

There is no withholding tax on the services when payments are made from the United Arab Emirates. The client may be situated in a free zone (Jebel Ali) and the free zone regulations should be checked for any tax concessions affecting the supplier. If compensation is on a rental basis this could involve payments being categorized as leasing or rental payments, however there is no withholding tax on these payments in the UAE.

Although the UAE has concluded a large number of double taxation agreements these cannot create a liability, but they specify the taxing rights of the contracting states in relation to each category of income.

Contract IV: Withholding Tax

The withholding tax position on fees for technical services depends on the local legislation as modified by the provisions of a relevant double tax treaty. Some countries may provide for withholding tax on service fees paid abroad. A double tax treaty may set out a maximum withholding tax rate that can be charged by the source country on technical service fees. This could be included in the treaty under the Royalties article or in a separate article of the treaty. The treaty would also provide for relief from double taxation.

Contract V: Withholding Tax

Withholding tax is imposed in Oman at 10% on dividend payments; interest; royalties; payments for services, management fees; consideration for the use of or right to use computer software; and consideration for research and development. It is likely that withholding tax will apply to payments under this contract for leasing and related services.

XX.5.3. Tax treatment of leased assets and of lease payments

Services are often provided using leased assets, which might take a number of different contractual approaches, which are of course defined by the circumstances of a particular project and the business relationships between the parties (e.g. long-term pricing arrangements). It is possible to consider the following structures:

- The service provider itself leases the equipment, using a finance lease structure, and uses the leased equipment in the resource state to provide services. Leaving aside the question whether the equipment creates/contributes to creating a PE (see below XX.5.6.), the issue is if WHT applies to payments to the lessor, assuming the service provider makes them from within the resource state point.
- The service provider leases the equipment to the resource company from a different jurisdiction, usually as an operating lease, and possibly has subcontractors providing staff as well as the service providers on teams to help operate the equipment. Again, the application of WHT to lease payments, and combination of services and leasing of equipment must be considered.

The language of UNMC Art. 12, includes payments for the "use of industrial, commercial or scientific equipment" within the scope of royalties; thus, an applicable treaty that uses the same language would allow a charge to WHT if prescribed in domestic law. The commentary to UNMC Art. 12, at Para 13.2. clarifies the scope of "industrial, commercial or scientific equipment" and it would seem that the equipment mentioned above would be within the scope of that definition.

However, there could be difficulties in establishing whether the payments made were actually for use of equipment. Para 13.3. of the commentary to UNMC Art. 12 discusses the application of the Article to cases of finance leases and points out that some of these transactions might fall under other provisions of a treaty, including both the business profits and other income articles. Thus,

application of WHT payments to lease transactions need to be analysed by reference to the lease terms (see list of criteria at Para 13.3. of the Art. 12 commentary).

There can also be additional complications on leased assets where associated services are included, as the lease element and the services element must be separated. As in the case of the second structure mentioned above, there may be additional services from a subcontractor that are integral to the contractual arrangement. However, if the service provider receives a gross fee combining both lease and service elements, it faces the challenge of deducting WHT when paying its own subcontractors. This results in double taxation and adds an unnecessary deadweight cost to the project. And while resource companies and service providers can try to mitigate this by the resource company paying the subcontractors direct after deduction of WHT, at times this might not be viable given contractual obligations, work warranties or to maintain business confidentiality.

XX.5.4. Computation issues

WHT poses a significant cost to service providers and subcontractors, who may in turn require contracts to be "grossed up" for WHT. This can, in turn, increase the possibilities of duplication of charge, as the grossed-up amounts (which contractually are payable by the resource company to the service provider) are then liable to WHT, resulting on a "tax on tax". To mitigate this, some countries have included a provision in their domestic law to avoid a WHT on the gross up of taxes, which resolves both the deadweight cost issue and the complications of computation. In the absence of such a measure, however, the gross up may need to be done iteratively to ensure that the service provider is able to receive the full amount that it has contracted for.

A further longer-term complication could be the impact of contractual terms such as "holds harmless" clauses, that require that the service provider will assume the tax obligations arising from a contract after the work has concluded. This can arise in particular with smaller subcontractors deployed by the service provider, e.g. in the circumstances mentioned in the second structure in XX.5.3. as direct subcontractors of the resource company. Where, e.g. the subcontractor is later considered on examination by the tax administration to be subject to a different WHT treatment, it is the service provider who can be liable for the tax due. This increases project risk for service providers and subcontractors, who then seek to mitigate the risk through their project pricing, which in turn increases the overall project cost to the resource state. As mentioned at XX.4.1., this is a particular challenge in resource countries that use a PSC/PSA arrangement, and the resource country itself bears a large part of the cost.

Improved and streamlined procedures for WHT, with clear guidance on computation issues, and relief where justified (e.g. avoiding "tax on tax") will help mitigate these costs and improve efficiency in raising revenues in the extractive sector. The commentary to Art 12A UNMC recognizes that there is a risk of excessive or double taxation at Paras 14 and 15 on the commentary to Art. 12A. The commentary provides some solutions to mitigate these concerns, including agreement to a reasonable rate of tax on fees for technical services.

XX.5.5. Use of ships and aircraft to provide services

Service providers will often use ships, and to a lesser extent, aircraft as part of their contracts with resource companies. Such equipment will include e.g. time or voyage charters of ships to transport products such as coal, iron ore, crude oil, refined petroleum products and LNG; some of these vessels will include specialized equipment to maintain the products during transport (e.g. LNG carriers). They will also use drilling or seismic exploration vessels, MODUs (Mobile Offshore Drilling Units), supply boats to offshore exploration and production platforms and inspection/maintenance vessels. A host of smaller craft such as LSTs for shallow water exploration support, guard boats etc. are also used. Aircraft used can include helicopters to transport personnel to remote mines, oilfields and offshore platforms, and other uses can be for supply and seismic surveys.

The broad guidance at the UNMC Commentary on Art. 12A clarifies that while payments for international shipping, air transportation or inland waterways transport could fall within the definition of "fees for technical services", any situation in which both Art. 12A and Art. 8 applies to the same services, the provisions of Art 8 prevails. Accordingly, payment flows from "the operation of ships or aircraft in international traffic, or the operation of boats in inland waterways" would need to be considered under the guidance on the UNMC Commentary on Art. 8. This guidance would therefore cover the bulk of transportation arrangements, whether of personnel or products, and the term "inland waterways transport" could presumably be interpreted to include transportation within territorial waters and the EEZ.

The guidance on Art. 8 in the Commentary to the UNMC would seem to be enough to cover the operation of transportation service providers to transport raw materials, crude or refined petroleum product, etc. since by definition these would be in international traffic or within inland waters. Any aircraft chartered to bring production crews on a one-off or regular basis from locations outside the resource state would also fall within the guidance of the commentary on Art. 8.

Countries can decide to make further expansion of the interpretation to include, e.g. transportation of personnel by helicopter to an offshore oil platform within the EEZ to be covered by this treatment, even though the language of UNMC Art. 8 does not cover domestic air transport. However, a country could decide to apply a strict interpretation, that does not consider such transactions to be covered by Art. 8. Accordingly, the payments would then probably fall within the criteria of "right to use industrial, commercial or scientific equipment". That treatment would apply whether or not the aircraft was provided on a crewed, charter or trip basis; however, it is possible that a resource company or service provider uses the aircraft on a "wet lease" from a provider outside the resource state. In such circumstances, the discussion above on leased assets should be consulted, and where the relevant treaty applied the equivalent of UNMC Art. 12, the payments would be considered royalties and be taxable in the source state. There can again be an issue of WHT being applied twice, especially where a service provider leases an aircraft, and then uses it to provide transportation services to multiple resource companies.

There is a further question as to whether certain specialised vessels and aircraft, such as a MODU or an aircraft involved in capturing seismic data would fall under the definition of "operation" under Art. 8. A similar issue would be the deployment of support craft such as supply or guard boats, dredgers used at the development stage of a project, floating cranes, inspection vessels, etc. which would typically be operated on time charter rates, i.e. on a crewed basis. However, there

might charters on bareboat basis, especially for ancillary or specialized craft, i.e. when the vessel is provided without crew and the service provider adds its own crew to deliver the service. These services would not fall within the scope of "…….operated in international traffic". The next question is to consider if they fall within the concept of "operation of boats in inland waterways".

XX.5.6. Order of charge/WHT procedures

WHT on royalties and fees for technical services are usually taxable in a resource state of whether the service provider or subcontractor has a permanent establishment (PE) in the resource state. However, the language of the UNMC provides, e.g. at Art. 12A, para 4, that where an enterprise of one Contracting State provides technical services through a PE and receives fees for those technical services within the scope of that Article, Art. 7 will apply to those payments in priority to the Art. 12A charge. Thus, WHT applies only in the absence of a PE.

The provisions of Art.12/12A UNMC are silent on the procedures to be adopted for WHT; the Commentary clarifies that each country can apply its own domestic procedures. This is also the practice in reality, and here, significant variations in practices apply. A particular problem can arise in the case of a (relatively common) "tax paid" PSC arrangement, where the NOC may have taken the obligation to "assume and discharge" all taxes due. In practice, however, the IOC partner, which has the contractual obligation to make the investments (to be reimbursed later through cost recovery) is obliged under domestic law to deduct the WHT. The service provider, or in many cases (depending on the contract), the IOC may then need to go through a cumbersome process of seeking reimbursement of the WHT suffered under the "tax paid" clause of the PSC, which inevitably imposes time and administrative costs.

Such administrative and procedural issues add to the deadweight costs of a project, which ultimately reduces the overall take to the resource state. Administrative regulations designed to address WHT in "tax paid" PSCs can thus be a simple solution that increases efficiency and overall gains for the resource state without costing any revenue. The WHT gain in these cases in only temporary as the resource state ultimately ends up refunding the WHT; where there is provision for interest payments with refunds, even the timing gain is lost. On the other hand, an administrative process that can solve this issue, e.g. by use of deeming provision that satisfies the WHT requirement, can save administrative time and cost on the part of the tax administration, the NOC, the IOC and the service provider.

Developing countries should also consider their overall revenue take from WHT application against the possible application of deemed PE determination. The application of "site" and "service" PE rules are examined below; while there might provision in a treaty to attribute income to such a PE, and apply corporate income tax to such income, there are concomitant issues of identification and administration of taxes on the PE, including proper allocation of income and expenditure, especially head office expenditure. Thus, tax administrations in developing countries may wish, consistent with their capacity to administer PE arrangements, to develop criteria to decide whether it was more practical to seek to apply WHT rules rather than to identify and establish a PE. This would be an objective standard, that considered revenue gains to the state, information gathering potential from a PE and administrative considerations to decide which would be more beneficial to the resource state. The criteria would be applied annually as an internal

measure and would of course only apply to cases where the service provider or subcontractor was actively contesting PE treatment.

XX.5.7. WHT administration issues for payers of income to service providers

XX.5.8. Relief for WHT in residence state

Relief for WHT suffered in the source state would need to be achieved in the residence state of the service provider or subcontractor within the rules, possibly based on Arts. 23A/23B of the UNMC, as negotiated in an applicable treaty, or possibly under unilateral relief rules of the residence state. Also, while double tax relief may be available in the residence state for foreign tax paid there may be limits on the extent to which the tax could be offset against the tax liability in the residence state. For example, where a country allows a credit for foreign tax paid this may often only be offset up to the amount of the tax liability on that income in the home country. If the foreign withholding tax exceeds the residence state tax liability on the profits from the overseas contract, the excess will effectively be an additional tax liability. While this is a wider issue than purely the extractive sector, the impact of that cost will be disproportionately high for a service provider or subcontractor operating on thin margins.

The residence state will also typically have documentation standards that have to be satisfied in this regard, and it is important for tax administrations in developing countries to be aware of the need for efficient procedures to meet the certifications and other requirements that a foreign service provider must satisfy to get adequate relief. There are many instances reported by service providers of delays in receiving adequate documentation to the point that they risk missing their filing deadlines. Often, these delays are caused by inadequate and unclear internal procedures, and a general lack of capacity, in many developing country tax administrations.

Improvement of compliance procedures and facilitation of the issue of withholding certificates are therefore a low-cost investment developing countries can make to facilitate the development of their extractive sectors. The increasing spread of Large Taxpayer Units (LTU) have improved matters in many developing countries; however, a service provider, or in many cases subcontractors, might be too small to fall within the scope of the LTU. Again, a simple administrative solution, alongside transparent procedures for administration of the WHT, could be handle the tax affairs of service providers and subcontractors of the extractive sector in the LTU, where such a Unit exists, alongside the tax affairs of resource companies.

XX.5.9. Good practices in filing and administration

Clarity on thresholds and documentation requirements, utilizing additional information sources to reduce compliance burdens, sharing of practices to reduce compliance challenges).

XX.6. PE issues in domestic law and treaties

XX.6.1. Domestic law and treaty definitions

Difference in definitions and impact on contractors/subcontractors using case studies; good practices in providing clarity and certainty to taxpayers)

XX.6.2. Scope of application and status of service providers

E.g. do domestic law or treaty provisions cover the territorial waters including EEZ of a jurisdiction or the continental shelf Status of service providers under older treaties before update to the UN model treaty

XX.6.3. PE identification and thresholds

Principles for PE identification for contractors/subcontractors. Should there be discussion on be included in 5(2)(f) UNMC? E.g. present Commentary silent but discusses drilling vessel, which can often be owned by a service provider;)

Contract I: Permanent Establishment

If the non-resident supplier has a permanent establishment (PE) in the host state, the company will be liable to corporate income tax on income earned. A PE may normally be created if the foreign enterprise has a fixed place of business in the host country, or if it concludes contracts through a dependent agent in the host country. Some countries have a provision for a "service PE" in their national tax law, under which a PE is created if a foreign enterprise has employees or other staff working in the host jurisdiction for a specified length of time.

If there is a double tax treaty the definition of a PE may be modified by the terms of the treaty. A treaty may contain provisions for a "service PE" specifying that a PE will be created if services are performed in the host country for a specified length of time. If the length of time the personnel will be required to work in the host country is sufficiently long (for example 90 days in any twelve-month period) this could give rise to a service PE in the host country.

If the performance of the seismic survey or the supply of the bits requires an office or other establishment in the host country this is likely to create a permanent establishment. Also, if the performance of the seismic survey involves the presence of employees or other staff in the host country for a period of time this could give rise to a "service PE".

Contract II – Turbo Drilling Services Permanent Establishment

If the non-resident supplier has a business connection with India the company will be liable to corporate income tax on income earned in India. A business connection is likely to be created when the qualified engineer and any other staff are performing engineering services in the host country. If, however there is a double tax treaty with India the liability to tax will depend on the existence of a permanent establishment (PE) as defined in the treaty. A permanent establishment

would normally be created by a fixed place of business in the host country or by the presence of a dependent agent who has the power to conclude contracts in the host country and who habitually exercises that power.

A treaty may provide for a "service PE" specifying that a PE will be created if services are performed in the host country for a specified length of time. If the performance of the engineering services requires an office or other establishment in the host country this is likely to create a permanent establishment.
In the case of the double tax treaty between the US and India the definition of permanent establishment includes the furnishing of services (other than those dealt with by the royalties article) by an enterprise through employees or other personnel, but only if: (i) activities of that nature continue within the other State for a period or periods aggregating more than 90 days within any twelve month period; or (ii) the services are performed within that State for a related enterprise.

Contract V: Permanent Establishment

The contract includes provisions requiring routine servicing and testing of the equipment and if this is done on site it will require the presence of employees of the contractor for certain periods of time.
Oman has adopted a definition of permanent establishment that follows the definition in the OECD Model Tax Convention. The definition of a PE includes a fixed place of business through which a foreign resident carries on activities in Oman whether directly or through a dependent agent. The definition also includes building sites and construction and assembly projects if they last more than 90 days. There is also a provision for a "service PE". This is created by the furnishing of services by a foreign resident in Oman, either directly or through employees or other personnel, if the activities continue for a period or periods aggregating at least 90 days in any twelve-month period.

XX.6.4. Site PE Issues

(Art 5(3)(a) UNMC) for service providers, Identification of service provider role in site, Contracts split over tax years, Contracts with break in services where unrelated sub of contractor has performed services, tests at para 11 of Commentary to UNMC in light of case studies)

XX.6.5. Service PE issues

(Art 5(3)(b) UNMC) and equivalent domestic law principles;

Connected services, 2017 Model no longer contains such requirement for adding periods as previously ("same or connected project" requirement), however, as most UN shaped treaties still have that, it should be discussed; maybe better call "same or connected project requirement"

Examination of question of establishing PE through performance of services including consultancy services, - applicable tests, split services, purely remote services such as seismic analysis, management and operation services performed on service client site, connected services under treaties signed under old model. Some provisions of bilateral tax treaties follow the wording of the UN model treaty in relation to the creation of a permanent establishment by the furnishing of services,)

Contract III: Permanent Establishment

Non-resident companies are taxable in the UAE if they carry on a business or a trade in the UAE through a permanent establishment. A PE is taxable under the same rules as resident companies. The expression "permanent establishment" is defined to include a branch, centre of management or other fixed place of business, and an agency but only if the agent habitually concludes contracts on behalf of the company. There is no specific provision for a "service PE" created just by the presence of staff performing services.
As the contract is to continue for two years the non-resident may need some form of fixed base in the UAE. The options should be assessed taking into account the requirements in relation to permanent establishments.

The domestic definition of a permanent establishment is often modified by the provisions of double tax agreements. The UAE has signed more than sixty double tax agreements but has not yet signed a tax agreement with the US. Corporate tax rates in the UAE rise progressively to a top rate of 50% on income over AED 5 million.

Contract IV: Permanent Establishment

The domestic tax legislation may impose a liability to tax on a non-resident company performing services in its territory. In this case a double tax treaty may include a definition of a "service PE" specifying that a PE will be created if services are performed in the host country for a specified length of time.
In the case of this contract if the length of time the personnel will be required to work in the host country is sufficiently long (for example 90 days in any twelve-month period) this could give rise to a service PE in the host country in which case the contractor would be liable to tax on profits arising from its activities in the host country.

XX.6.6. PE Issues around use of subcontractors by contractors

(UNMC language around "by an "enterprise through employees or other personnel engaged by the enterprise for the purpose in a jurisdiction" Some countries view crews on rigs as "mariners" while some do not.

XX.6.7. PE issues around split contracts

(attribution of service by nonresidents to PEs of group companies, services split between related parties, connected services attributed to different companies, digitalization of services as enabler) XX8.4 deals with the BEPS 7; to avoid overlap, this is to be called pre-BEPS

(construction, assembly, installation, services PE , splitting up etc. Occasional reference to subcontracting) Splitting up to avoid meeting PE threshold Art 5(3)(a)) and Art 5(3)(b) including PPT (29(9): Com page 158 and 159 section 52-53 quoted from OECD Com explicitly mentions contractors and subcontractors (especially on continental shelf) and also contains the specific anti-splitting provision (SAAR) which may be included but only focussed on 5(3)(a) .

On page 159 specific UN Com on extending and amending the previous provision to also include splitting up of services in 5(3)(b)!
Art 5(3)(a) Com pages 160-162; period spent by subcontractor on site main contractor and subcontracting all parts of a project. Also, special case of partnerships, and removal in 5(3)(b) UN Model of requirement "for the same or connected project".

Com pages 792 and 793 , Art. 29(9) PPT, example N on splitting in case of Art. 5(3)(b)
(OECD Com 5(3) pages 129-130 anti-splitting; Com pages 157, section 144 end alternative provision for services PE in fact deals with subcontracting without explicitly mentioning as services by an individual performed for an enterprise not treated as performed by other enterprise – the main contactor- unless the latter supervises etc. that person. So different approach as regards subcontracting services compared to subcontracting on building sites etc. (circumstances also different).

XX.7. Indirect taxation issues

XX.7.1. Key issues

In principle, VAT should not enter the profit or loss account of subcontractors; input VAT paid on purchases should either be offset against output VAT received from purchasers or be refunded by governments. Complexities in the sector do, however, provide challenges in applying, complying with, and administering the VAT.

The key VAT issues regarding subcontractors are:

- Territorial scope of the VAT; when is a supply exported?
- Cross-border supplies of services and intangibles; where is a supply supplied and consumed?
- Refunds; how can they be avoided and paid when they do arise?

Note that these issues are not specific to subcontractors but arise throughout the extractive sector. Chapter 9 of this Handbook deals in-depth with the questions raised above. This chapter only provides the solutions to the cases described. In doing this, it is assumed that all countries apply a VAT to imported and locally produced goods and services. Exported goods and services are zero-

rated, meaning no VAT is charged on exportation and all input VAT can be deducted or should be refunded.

Contract I: Value Added Tax (VAT)
The first question that needs to be considered is whether Company P-who provides a service to Company Y- is registered or required to be registered for VAT in Country A. If Company P is not registered for VAT in Country A, it may be required to do so, depending on the legal requirements. This will also depend on whether the services supplied are regarded as imported services, or services supplied from within Country A. It is unlikely that registration is required if services are deemed to be imported, but the applicable law should be consulted to confirm this.

Company P will be able to deduct all "Country D input VAT" in their tax return to the revenue service of Country D. Company P will only be allowed to deduct "Country A input VAT" in their tax return to the revenue service in Country A, if they are VAT registered in Country A.

Whether Company P should charge "Country A output VAT" on the supply to Company Y, will depend on where the service is deemed to be supplied and consumed.

If the service is deemed to be supplied from outside of Country A and not consumed in Country A – the EEZ is deemed to be outside the VAT jurisdiction of Country A -, no "Country A VAT" will be applicable.

If the service is deemed to be supplied from outside of Country A, but consumed in Country A, Company P will not charge "Country A output VAT", but the service will be an imported service. This means that Company Y will have to either pay "Country A output VAT" and deduct this VAT paid in a future tax return, or ideally Country A applies the reverse-charge principle; Company Y does not pay VAT. It should be noted that the net VAT received by government is nil under both alternatives.

If the service is deemed to be supplied from within Country A and consumed in Country A, Company P will likely have to register for VAT and charge "Country A output VAT" on the supply of the service. If Country A's legislation does not require VAT registration, then no VAT is charged on the supply of the service.

It is clear from the above that it is important to determine where the service is supplied and consumed. Generally, determining the place of consumption is straightforward, but the extractive industries may provide some challenges in this regard. This is especially the case for off-shore extractive activities. Determining the place of supply of a service is often challenging. In the case above, the place of supply can be in Country A, Country D, or Country B. It is also possible that the place of supply is partial to each of these countries. Many jurisdictions have specific place of supply rules to assist in determining the VAT consequences of interjurisdictional transactions. The OECD also provide useful guidelines where such rules do not exist.

Contract II: VAT

The VAT consequences of this contract is similar to Contract I. The primary difference is that goods, and not only services, are supplied by Company P and that a local supplier, Company Q who is most likely registered for VAT, provides logistic services to Company P.

The interjurisdictional VAT treatment of the supply of goods provides a lesser challenge than services. Goods are clearly observed and flow through customs. When leaving customs, imported goods are generally charged with domestic VAT, in this case "Country A output VAT". This VAT is paid by Company Y to customs and can be deducted from Company Y's next VAT return. The issue here is that most likely, Company Y will not have charged sufficient output VAT to offset the input VAT deduction, resulting in a VAT refund owed to Company Y by the revenue service of County A. If this refund is not paid, or paid with delay, this involves a direct cost to Company Y – the VAT enters the profit and loss account. One way to avoid this, as discussed in Chapter 9, is to apply an accounting-only-deferred-VAT principle to imported capital goods by participants in the extractive sector. If this rule is applied, Company Y will not pay VAT to customs, declare output VAT in its next VAT return, and immediately deduct input VAT equal to the amount of output VAT paid. See that the net VAT returned to government is nil, exactly the same is would be the case if Company Y paid VAT to customs and was refunded this amount of VAT. The benefit is that Country A is most likely a more attractive investment location for extractive participants because of the accounting-only-deferred-VAT principle applied.

Company Q provides a service to Company P. If the service is deemed to be consumed in Country A, Country P will charge "Country A output VAT" on the supply of the service. If the consumption is deemed to be outside of Country A, the service will be exported and zero-rated. Company Q will be allowed to deduct input VAT in either event. Company P will only be able to deduct input VAT if (1) Company Q charged "Country A output VAT", (2) Company P is VAT registered in Country A, and (3) the services provided by Company P will be charged with "Country A output VAT".

Contract III: VAT

In this contract, the primary difference to the previous contracts is the amount of activities performed in the resource state. As a general principle, being allowed or required to register in terms of a countries VAT law, increase with the amount of activities – not supplies – in that country. The differentiation between activities and supplies is important. A Company can have only a single supply in a country, but multiple and long-term activities in that country. In such a case, registration is likely to be required and allowed voluntarily. Conversely, a company may have multiple supplies in a country, but very few or no activities. In such a case, registration is likely not required and not allowed – the supplies will be imported goods and services. Different jurisdictions have different legal phrases to capture this general principle, for instance, economic activities, regular activities, or continuous activities.

Contract IV: VAT

In this Contract, all parties are likely VAT registered in Country B. Company P will be allowed to deduct all "Country B input VAT", irrespective of the deemed place of consumption of the

services. If "Country B output VAT" is charged, Company X will be allowed to deduct this VAT paid as an "Country B input VAT: Whether "Country B output VAT" is charged will depend on whether the service is deemed to be consumed in Country B, or outside of Country B – is the offshore oil platform located within the VAT jurisdiction of Country B.

Contract V: VAT

Lease agreements are generally treated as consecutive supplies for VAT purposes. Cash-flow issues may, however, arise where an invoice is created indicating the consideration to be paid over the entire lease period, but actual payment is only made throughout the leasehold period. Most jurisdictions require that VAT be paid on the earliest of invoice or payment, for the amount indicated on the invoice or received as payment. It is therefore generally advised that countries should have special rules regarding the time of supply of large capital purchases. The preferred rule in this regard is that VAT becomes payable as payment is received, not on the invoice basis.

Contract VI: VAT

It is important to understand that VAT is charged on *the supply* of goods and services, as opposed to goods and services. This means that a single good or services, may be supplied multiple times, concurrently. In this contract it should be determined what portion of the good and services are supplied to which recipient. Hereafter, separate invoices should be generated to reflect the consideration for these separate supplies. Whether these supplies are charged with output VAT, zero-rated, or not charged with VAT depends on the place of supply and consumption of these goods and services, as discussed in the previous contracts.

XX.7.3. Use of special regimes

Supplies by a party with a temporary place of supply, Voluntary VAT registration in a jurisdiction/reclaiming inputs, use of credit mechanisms for resource companies to encourage registration, Inter State movement of capital equipment and its treatment for GST/VAT purposes specifically in EU and countries like India.

XX.7.4. VAT issues for contractors in decommissioning/rectification

(*no client output VAT to be relieved, refunds mechanisms)*

XX.7.5. Customs duty and import VAT issues

temporary admission issues such as high value exploration equipment brought in temporarily, classification issues – (e.g. is a MODU a vessel or not), Application of charges and use of depreciated value for re-export, multiple users of same equipment, tracking of assets subject to incentives, valuation of assets, establishing benchmark values, ringfencing of assets, rules for second hand equipment, rules on related party asset transfers, project area limitations for incentives).

XX.7.6. Good practices for VAT and Customs treatment

in negotiating concession agreements

XX.7.8. VAT issues for subcontractors of service providers

– *application of reverse charge mechanisms*

XX.7.9. Administration issues of refunds and registration

(Application of domestic provisions on VAT registration and refunds, alternative and more efficient solutions, recognition that short-term nature of work is Service Providers may cause difficulties in jurisdictions where it takes a long time to register for VAT/GST)

XX.7.10. Treatment of services procured by Head Office for VAT purposes.

In the short-term contract market, it is industry practice to share the procurement of services between Head Office and the local PE as well as for centralization of certain work at Head Office/Regional Office level.

XX.8 Payroll Taxes

XX.8.1. Mobile employees and the payroll entity

Service providers and subcontractors regularly deploy personnel in resource states who are essential to the delivery of services. Such personnel can be part of the service contract, i.e. they operate the equipment, deliver tasks within the contractual framework for services, etc.; alternatively, the service can be a staffing service, where the provider is essentially deploying staff who work on the resource company's site and with their equipment. A further complexity arises from the specialized nature of the work involved where many essential skills are provided by individuals, who for a variety of reasons prefer to remain self-employed and hire themselves out on a daily rate basis.

The first issue to consider is thus to determine whether an individual is an employee, either of a staffing company or of a service provider, or alternatively whether that person is an independent subcontractor, which raises a different set of tax issues. These are considered separately at XX.9.1, which also covers the treatment of employees of a service provider who are considered the employee of a resource company; XX.9.5. deals with the treaty aspects including relief from double taxation. This section of the chapter focuses on individuals treated as an employee.

The second issue to consider is which entity will be considered to be the employer under domestic law in the resource state. Depending on the rules regarding tax characterisation of employment income under domestic law, there may be a determination that a resource company that utilizes the services of a staffing services provider is the actual economic employer of the personnel deployed, irrespective of the fact that the legal employer is the staffing company. The

consequences of this interpretation might be quite significant in cases where the resource company has operated on the assumption that it has no liability as an employer; beyond the immediate issues of liability for payroll tax and withholding obligations, this may also give rise to complications in settling cost sharing arrangements on the investor side.

An associated issue around payroll tax in this regard relate to the issuance of work permits. This is because some countries require the statement of gross salaries and their payment mode on the work permit. The tax aspect arises from the calculation of gross income, as this can depend on the payment mode mentioned in the work permit. A work permit might specifically mention the monthly gross salary; the complexity arises where the employee deployments are for specific periods shorter than a full month. The tax administration may then still assess the stated total monthly gross salary.

Tax administrations should consider issuing guidance on payroll that sets out criteria by which a resource company can achieve certainty, including perhaps the possibility of an advance rulings system on payroll issues. Guidance on assessment criteria and a willingness to consider compensation terms that respond to the day rate practices common in the industry would also help these companies achieve clarity on their tax treatment and reduce risks.

Contract VII – employee working overseas

Employment contract

The employee is to be located in the overseas country for a period of nine months, to perform technical services to be performed in relation to the company's products on onshore oil wells. The necessary equipment is to be supplied by the company.

The employee will be paid in the local currency. Travel expenses to and from the host country at the start and end of the period of work will be paid for by the company. A period of four weeks paid vacation will be provided. The salary for the term of overseas employment will be EUR 100,000 and some additional benefits will be available as specified in the contract. Working hours and overtime pay will be on the same terms as are available to employees in the home country. The current pension plan arrangements will continue and contributions to relevant social security schemes will continue.

The relevant visa and work permit are being arranged by the company. The employee will reside in accommodation in the host country to be arranged by the company. The company is to arrange for car hire and medical insurance for the employee in the host country.

XX.8.2. Employee tax residence, WHT and computation of income

The third issue to consider is the tax residence status of the employee. Where a person is going abroad to work as an employee of a company resident in the home jurisdiction of the employer, the employee may become non-resident in the home country for tax purposes and resident in the resource state. This depends on the residence rules in the two jurisdictions and on the terms of any relevant double tax treaty. Art 15 UNMC covers Income from Employment and essentially

provides for income from employment to be taxable in the state where the employee is present and performing the work. This principle applies to salaries, wages and benefits in kind and should apply without any regard to where the income is paid to the employee. The exception from the general rule is where the employee is present in the other state for not more than 183 days in a tax year. The other conditions are that the salary is paid by an employer who is not resident in the state where the employee is working, and that the remuneration is not borne by a permanent establishment of the employer in that other state.

This means that only those staff working abroad for short periods could remain exempt from tax in the destination country. This exemption allows employers to send employees to work for short periods in other states without the employees becoming liable to tax in those other jurisdictions. However, if staff are going to live and work in the foreign country for longer terms or will be working for a foreign employer the treaty provisions will not prevent them becoming resident in the foreign country. Accordingly, the exemption, provided for by many treaties will often not be applicable to employees working abroad.

Some additional factors also need to be taken into account in determining residence and taxability. E.g. in one country, individuals with a presence of 182 days or more in an income year or a presence of 90 days or more in an income year and of 365 days or more during the preceding 4 income years are deemed residents for tax purposes. Since most successful extractive projects are long term undertakings, it is possible that employees who may consider themselves non-residents may be considered residents under domestic law due to their frequent travel and presence in the country over a period of time. The UNMC Commentary, which essentially repeats the guidance in the Commentary to the OECD Model, provides detailed guidance on this treatment. The difference in tax treatment between residents and non-residents can be significant. A non-resident may be taxable on a gross basis through a WHT, while a resident will usually be able to benefit from allowances, rebates, credits and exemptions available under domestic law.

The fourth issue to consider is the quantification of the income that is subject to tax as employment income. The contract of employment may allocate different values for work done by the employee in the resource state, and work done either in the residence state or a third country. There may also be the possibility of a split contract, where the employee is paid a salary for his work in the resource state but may also be paid a proportion of salary to defray costs such as maintaining a home, pay education costs, etc. in the residence state. There may also be a risk that a split contract has been entered into, under which the employee receives a proportion of their employment related income in a foreign bank account, without any separate duties or rationale cited as the reason of such a split. The challenges for a developing country tax administration in these cases lie in identifying the nature of a split contract to test whether there is an actual rationale for such a split or is simply a crude form of tax evasion.

These challenges could be significantly mitigated by guidance on available thresholds for establishing tax residence, declaration procedures to show actual total compensation paid and what duties such compensation is intended to compensate and treatment of short-term employment contracts.

XX.8.3. Applicability of Social Security and worker fund contributions

The employer and employee may jointly agree continuing to pay social security contributions in the employee's home country to maintain the right to a state pension and other benefits. There may be other contributions and perquisites that are paid by the employer directly in the residence state of the employee. Most developing countries do not have the elaborate network of social security arrangements common in many developed countries, and the employee will be unlikely to want to give up those rights. The issue that follows from this is whether such contributions by an employer should be included in the total compensation package of the employee.

An associated issue is the contribution to be made to any worker compensation scheme or other industrial labour welfare funds in the resource state. The employee, typically a non-resident, is unlikely to access the fund but on the other hand such contributions are usually mandatory. The employer would be liable for fund contributions to such funds if they meet the criteria, and typically most large service providers would probably qualify. And where the responsibility to withhold payroll taxes shifts as a result of a determination by the resource state that the true economic employer as described in XX.8.1., the resource company or service provider may be liable for significant sums of money over the life of the project, which were not within the cost analysis done for the investment. Further, in the absence of social security totalization agreements, there is little opportunity for the employee, normally tax resident in another state, to benefit from contributions made in his/her name.

XX.8.4. Registration and administration of payroll

Service providers, and especially the smaller subcontractors, may retain a local payroll company to handle payroll as they themselves may not have the size and scale to do so efficiently. Further, such a payroll company can also be a service provider to the resource company. However, there can be risks on the application of VAT and potentially withholding taxes from the client companies to the service provider. A country might have language in its taxing statutes regarding a WHT on gross income; it is thus possible that tax officials consider the entire transaction as subject to WHT and VAT, including the salaries which would be paid to the employees. It is therefore worthwhile for governments to issue clear guidance on this area that clarified that only the service element of payroll management would be subject to WHT and VAT.

There may be a need to consider the tax formalities associated with the shift of residence, where appropriate. Either the employee or the employer would need to notify the tax administration of the date on which the employee is leaving his state of tax residence, country and any relevant form or tax return should be completed and sent to the tax administration. The employee may need to request a tax return to declare the income earned in that tax year up to the date of departure from the country if that is required by the national tax rules in the home country. It would also be appropriate to consider special rules regarding expatriate employees, and possibly special occupations such as development work, work on ships or work on oil and gas platforms.

XX.8.5. Treaty benefits in deemed profit jurisdictions.

Satisfaction of clause 15(2)(c) of UNMC, remuneration borne by the deemed employer in the host country in absence of presence of legal employer

XX.9. Small subcontractors or short-term subcontractors to Service Providers

XX.9.1. Status and characterization of subcontractors for tax purposes

The extractives services sector is characterized by layers of contractors, down to individual service companies and a chain of companies could result from a particular contract to execute a single set of tasks. An issue that often comes up is the tax status of the subcontractor, and whether he/she should be considered to be an employee. Allocation of taxing rights for employees is made under Art. 15(2) UNMC. The Commentary to Art. 15 UNMC generally replicates the guidance from the Commentary to the OECD Model, which clarifies, at Para 8.4, that it is for the source state to characterise contracts of service vs. contracts for services. Paras 8.5-8.9 then clarify that such recharacterization may take place even where domestic law in the source state does not have provision for questioning a formal contractual relationship between an employer and employee.

Domestic law of the resource state may have some tests established by case law or precedent, or set by statute or administrative guidance; however, there may well be differences in interpretation that may lead to different view between a tax administration and the taxpayers in question. Assuming that the domestic law requirements for identifying a contract for services are not satisfied, a resource state tax administration, relying on its own rules for contracts of service vs contract for services, may insist on treating subcontractors as the employees of the resource company or the service provider. This could be done on the basis, e.g. that the individual in question is purely providing labour and is using the site, equipment and materials provided by the resource company/service provider to do so.

The consequence of such a determination of the relevant employer, especially in retrospective situations, can have potentially significant consequences. The employer of record would then be liable for compliance with rules regarding payroll taxation of employees, including WHT, labour fund and social security contributions, as well as sanctions and interest on delayed fulfilment of employer obligations. On the other hand, the staffing company would have already deducted the relevant WHT and other levies and paid them over. The resource company would then be faced with a long and complex process to recover such misapplied WHT and levies, assuming such a procedure is allowed by law, resulting in significant costs that would potentially be partially borne by the resource state in cost sharing mechanisms. Similar issues arise in recharacterizing service providers from independent subcontractors to employees, see below.

Developing countries could consider establishing an advance rulings system to address these specific tax characterization issues for employers and employees as part of the administrative arrangements for extractive sector taxation. This function could be located in the LTU if there is one, or a tax administration office that deals with extractive sector taxation.

XX.9.2. Tax issues related to subcontractors recruited through staffing companies

The chain mentioned at XX.9.1. may include numerous intermediaries, including subcontractors who provide staffing services to both resource companies and to other service providers. An issue that creates complexity for both resource companies and the larger service providers is the tax treatment of subcontractors retained through staffing companies.

Where the staffing company is a non-resident, but the resource company or service provider using services of subcontractors are tax resident or have a PE in the resource state, the tax residence/PE status of the staffing service provider may create uncertainty and characterization issues. Assuming that the staffing service provider is considered the employer of record, it will be responsible for all the compliance responsibilities for payroll as discussed at XX.8. However, the domestic rules for payroll administration may have been designed to be done by a tax resident. This would be the normal case for the majority of employers, the phenomenon of non-resident staffing companies being a feature in a limited range of businesses like the extractive sector. There may also be indirect tax issues on provision of the service, see below.

The typical approach taken by a non-resident staffing provider is to retain an accounting firm in the resource state to provide the accounting and payroll management. However, the tax administration of the resource state may not be willing to accept such arrangements and may impose compliance requirements intended to safeguard national revenue, which end up adding to the cost to project.

XX.9.3. Tax issues related to individual service companies

Where individuals work for a period on an extractive project in a foreign country they may structure the contract differently, working for an umbrella company or for their own service company, rather than as an employee subject to payroll taxation rules, as above. An individual using a service company would of course be liable to tax in the resource state on the profits earned there. There is however a legitimate concern on the part of tax administrations to combat disguised self-employment, and there are tax provisions in various countries to ensure that tax paid through a personal service company is not more favourable than tax that would otherwise be paid by the individual contractor.

Where the individual is working for a service company the domestic law or tax treaty rules will apply in the same way to impose either a WHT or net taxation based on a PE, depending on the services provided in the resource state and period for which such services are delivered. The PE rules regarding a “service PE” and/or a “site PE” would apply in the normal way; see XX.6. However, if the relevant treaty includes provision equivalent to Art. 14 UNMC, a separate question to address is whether income from these services are allocated between the two states under this Article.

The default position for developing countries seeking to attach tax liability to individual service companies should start from consideration of the PE issues under the equivalent of Art. 5. If, however, the services in question are provided by a single individual and application of the PE rules proves difficult, the issue revolves around whether the resource state has rules that allow

lifting the "veil of incorporation", i.e. looking through the corporate structure to the underlying individual owner of the service company. If this is available, and there is the equivalent of Art. 14 UNMC in the relevant treaty, the resource state may be able to impose tax if the individual is present in the country for a period or periods aggregating at least 183 days in any twelve-month period commencing or ending in the fiscal year concerned, even if there is no fixed base.

This alternative treatment may be considered in cases where attachment of liability under the PE rules is difficult and Art. 14 treatment provides a more favourable result. Only income derived from activities exercised in the resource state, however, may be taxed. It may be efficient to also use this approach to apply taxation to the categories of income mentioned in UNMC Art. 14, i.e. "the independent activities of physicians, lawyers, engineers, architects…..", many of which would apply to the contract development stage of an extractive sector project.

A final issue is that the tax administration of the resource state may ignore the service company and insist on treating the individual subcontractor as an employee for income tax purposes. See further XX.9.1.

XX.9.4. Tax treaty issues

The discussion at the Commentary to the UNMC, which reproduces the OECD Commentary on this point, clarifies at para 8.10 that recharacterization by the resource state of a contract for services as a contract of services should not prevent relief from double taxation by the residence state. This would also apply where an employee of a service provider or a larger subcontractor performs services in the resource state, in which case a hired-out employee is actually in substance considered to be employed by the resource company. Para 8.12 clarifies that any disagreements between the resource state and the residence state of the subcontractor or service provider can be resolved through a MAP procedure or following the examples provided by the Commentary. The examples at Paras 8.22 and 8.24 are particularly appropriate and could be consulted.

Address issue of deemed PE on continental shelf which has effects under traditional art.15 application but also special rules not requiring 183-day presence for taxing the salaries.

XX.9.5. Indirect tax issues for small subcontractors and staffing companies

Some VAT issues may also arise for foreign contractor services where provided by small subcontractors and staffing companies. VAT may be chargeable on the total consideration of charges, fees or receivables on issue of the invoice, with the use of a reverse charge mechanism where the recipient is a non-resident. The issue is of particular importance to staffing companies, where the tax administration might consider the entire payment as subject to VAT, including the salaries which would be paid to the employees. It is therefore worthwhile for governments to issue clear guidance on this area that clarified that only the service element of payroll management would be subject to VAT.

Service providers might also have some compliance challenges with small subcontractors who are not equipped to deal with VAT. Their contract arrangements may have a "net of tax" clause; while this does not remove the need to maintain VAT compliance, in effect, the service provider or

resource company will be performing the VAT computation and compliance function and making the payment on their behalf. This would approximate a reverse charge in economic terms, even though the subcontractor in question may be providing services in the resource state. A simplified compliance procedure which allows the acquirer of services from providers within the resource state to meet VAT compliance requirements of providers could facilitate compliance for small subcontractors.

XX.9.6. Administrative and compliance issues

Requirements regarding the administrative rules for payroll administration for subcontractors recharacterized as employees may result in further complexities. The employer in most cases is required to withhold tax and deposit the tax quarterly or monthly. Final adjustment may sometimes need to be made in the last quarter for over or under deduction of tax. However, where recharacterization has taken place, the withholding liability will apply from Day 1 of the transaction, and applicable sanctions may also take effect from that date. This adds to the risks faced by the resource company or service provider and ultimately adds to the costs of resource extraction.

Further, where a subcontractor who has multiple staff in a resource state and are deemed employers of the staff liable to withholding requirements has left the resource state when queries are raised, the resource state may have little possibility of recourse from the ultimate subcontractor. A possible approach to a solution to this challenge could be establishing a chain responsibility including for instance for wage tax, public and employee social security rules.

A further solution may lie in establishing clear guidelines on non-resident employers with perhaps a definite requirement to retain a local firm to comply with local rules.

XX.10. Other tax issues relevant to service providers and subcontractors

XX.10.1. Risk assessment and

(Conclusions drawn from case studies, issues thrown up by greater use of intangibles, complications from fragmentation of physical operations and business functions in digital economy, reduced need for physical presence)

(Clarity on characterisation of transactions as technical services, and related guidance)

Derivations and destinations table for case studies.

XX.10.2. Treatment of service companies within incentive regimes for the extractives sector

(*major item in the mining industry)*

XX.10.3. Contractor treatment in Production Sharing Contracts

(E.g. there may be provisions affecting subcontractor tax in PSCs and in some cases a rate of withholding tax on the subcontractor or specific treatment for VAT may be set out in the agreement.)

XX.10.4. Role of NOCs in "tax paid" PSC structures

Status of subcontractors.

XX.10.5. Application of fiscal stability clauses to subcontractors

XX.10.6. Other policy areas

(Local content, skills dev and training, coordination between ministries)

XX.10.7. Dispute resolution

Subcontractor has been in dispute that could not be resolved and has left the project hanging. Dispute did not get resolved and the knock-on impact can be great.

XX.10.8. Models for good practices

(*Use of ATAF Models?*) .

Deemed profit arrangements? Option?

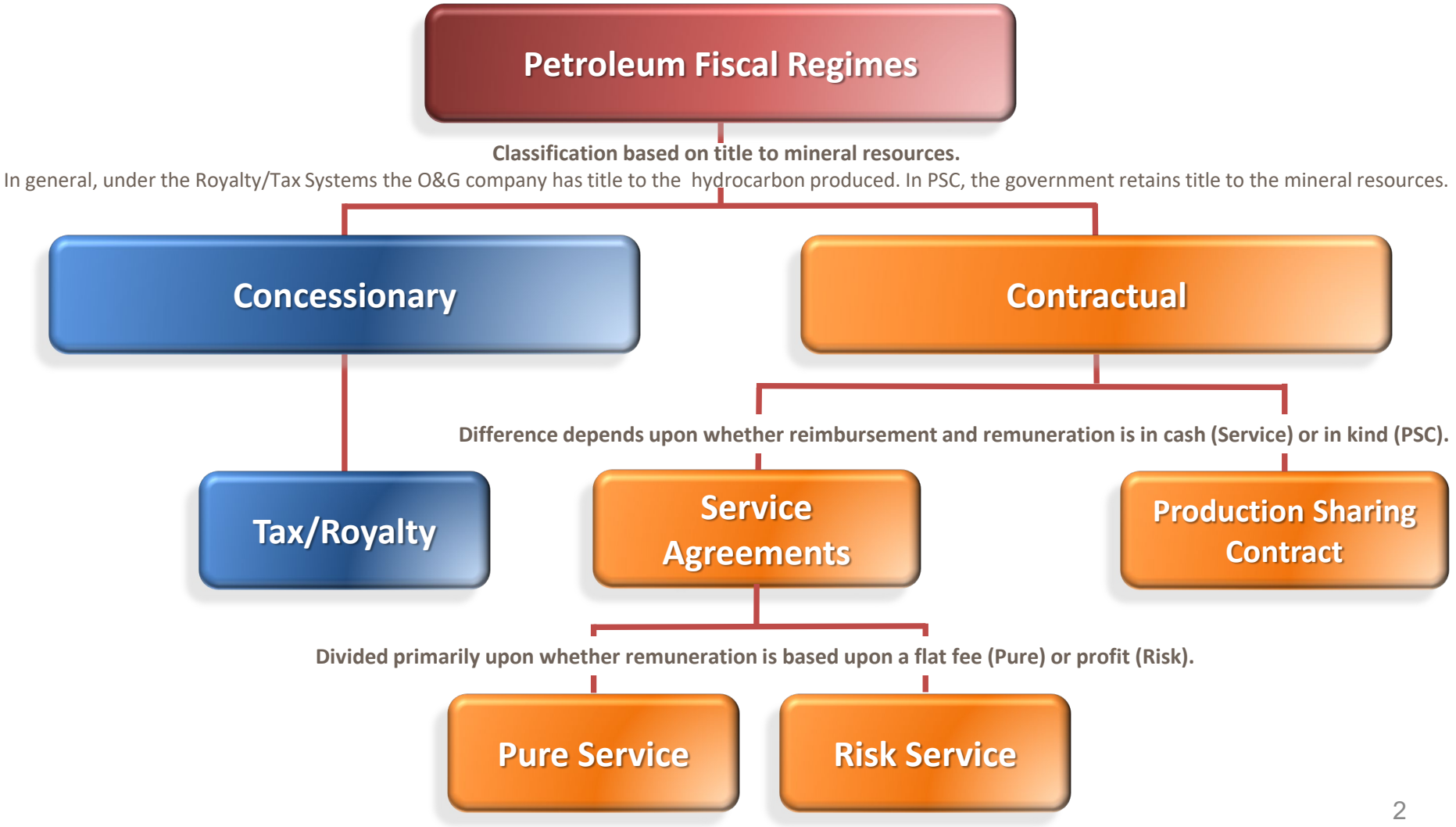
(Annex 2)
Production Sharing Agreements (PSC)

Features and tax implications in the Oil&Gas (O&G) sector

DRAFT FOR DISCUSSION

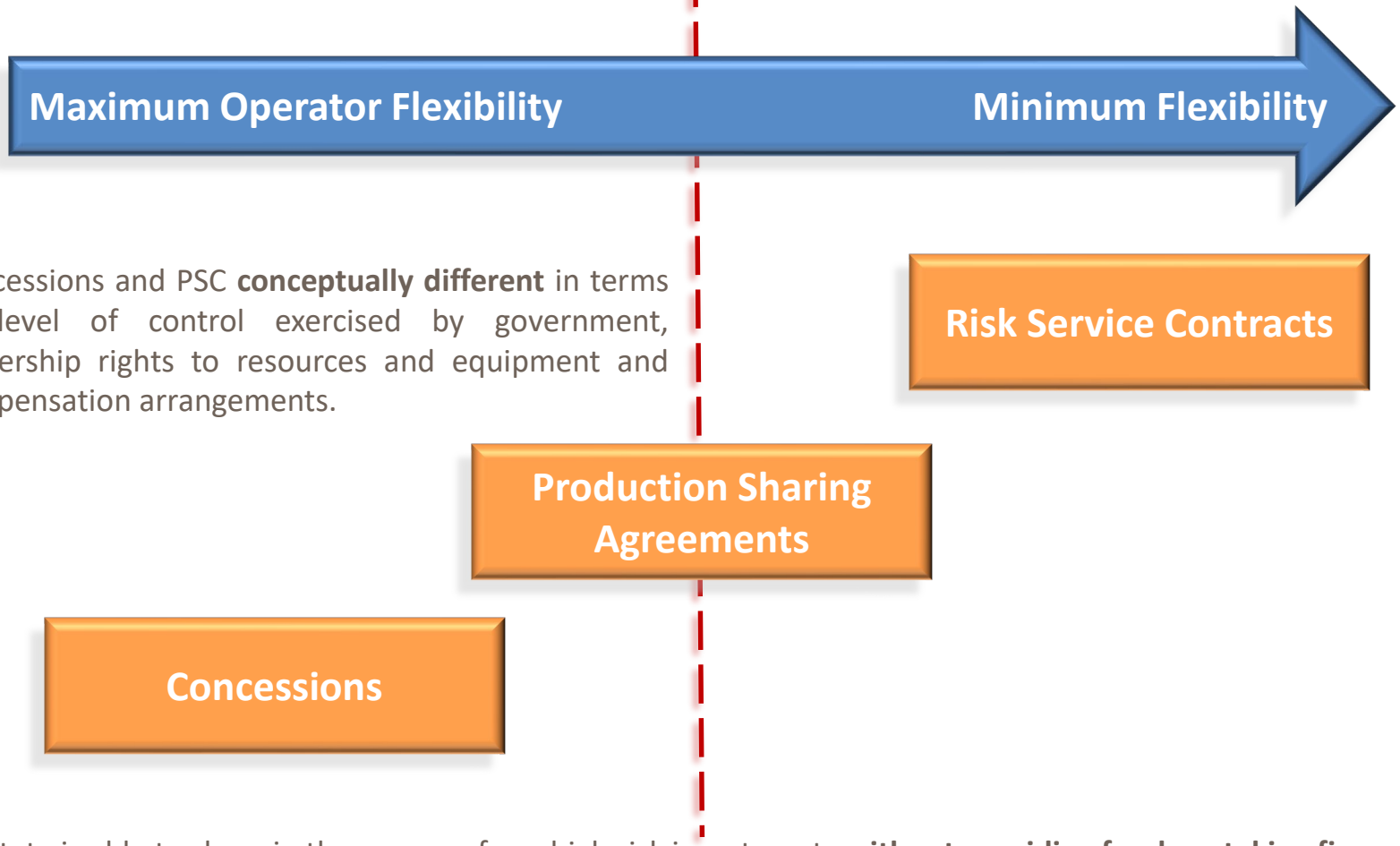
United Nations, April 2019

Fiscal System Taxonomy



Fiscal System Taxonomy

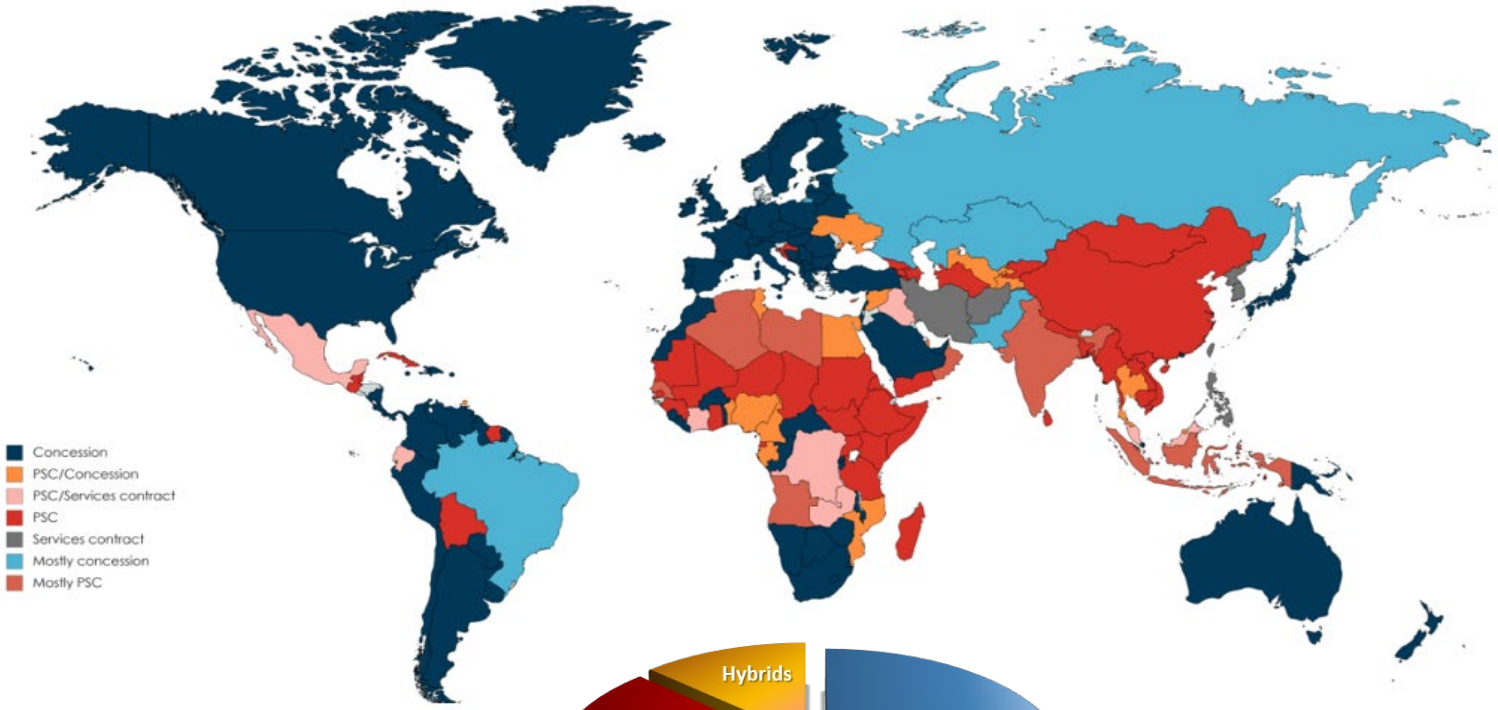
The issue of ownership is the **fundamental distinction** between the concessionary and contractual systems. Under concessionary system, the contractor has title to O&G produced. Under PSC, government retains title to resources.



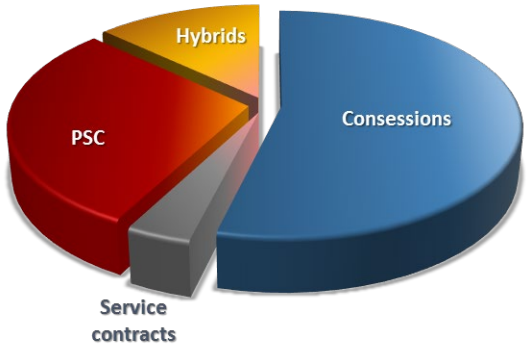
In PSC the State is able to share in the revenue from high risk investments **without providing funds or taking financial risks**.

Fiscal System Taxonomy

Each country establishes the type of fiscal systems that best meet their sovereign need.



PSC widely used in developing countries.



No uniform approach: hybrids systems.

Origin of PSC

- First PSC was signed in **August 1966** with Permina, the former Indonesian National Oil Company (currently Pertamina).
- This contract embodied the **basic features of the PSC concept**:
  - **Title** to the hydrocarbons remained with the State,
  - **Permina maintained management control** and the contractor was responsible to Permina for execution of petroleum operations in accordance with the terms of the contract,
  - The contractor was required to **submit annual work programs and budgets** for approval by Permina,
  - The contract was based on production sharing (no profit-sharing) basis,
  - The contractor provided all **financing and technology required** for the operations and bore the risks,
  - After allowance for up to a maximum of 40% recovery of costs, the remaining production was shared 65/35% in favor of Permina. Taxes of the contractor were paid out of the share of Permina,
  - All equipment purchased and imported into Indonesia by the contractor became the property of Permina.

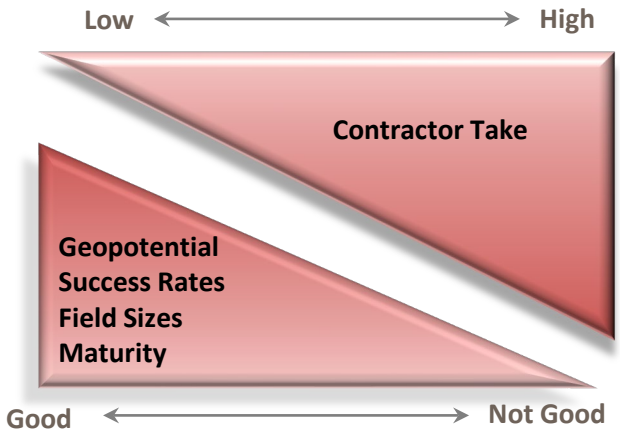
- **Primary elements of a PSC include:** (i) bonuses, (ii) royalty, (iii) cost recovery, (iv) profit oil split and (v) taxes.

Design of a PSC fiscal System

- **Broader or macro policy objectives** from a government perspective are to:
  - Maximise income from the country's natural resources
    - Exercise control over petroleum resources
    - Increase employment
    - Ensure social and economic growth

- **Political and geological risks** are to be taken into account as well as the potential rewards flowing from, amongst others:
    - Expected volume of hydrocarbons
    - Oil and gas prices
    - Costs of extraction, depending of the type of oil or gas block, i.e. onshore or offshore

- **Clarity and simplicity of fiscal rules** – common criticisms are:
    - Complexity resulting in misinterpretation, uncertainty and loopholes
    - Difficulty to implement
    - Unstable over time and likely to lose credibility
    - Capacity constraints on fiscal administration



Parties to a PSC

- **Contractual agreements** are concluded between one or more oil and gas companies (contractors) and a State entity, which could be:
  - A government department
  - A Ministry
  - A government agency
  - National oil and gas company

- **Coordination between government departments** on the policy with regard to the hydrocarbon industry is required.
- **Ministry of Finance and Tax administration representation** is important when a PSC is negotiated and the contract is finalised.

Choice between Tax/Royalty and PSC

- From a strict tax perspective there is **no intrinsic reason to prefer a tax/royalty regime to a PSC regime**, since the fiscal terms of a tax/royalty regime can generally be replicated in a PSC regime, and vice versa:

Risk/Reward Trade off	Tax/Royalty	PSC
Low risk to government	Royalty	There may be an explicit royalty; or there may be a limit on cost oil that functions as an implicit royalty.
Medium Risk	Income Tax	Income tax, which may be paid out of the government´s share of production.
High Risk	Resource Rent Tax	The determination of the amount of profit oil can mimic a resource rent tax.

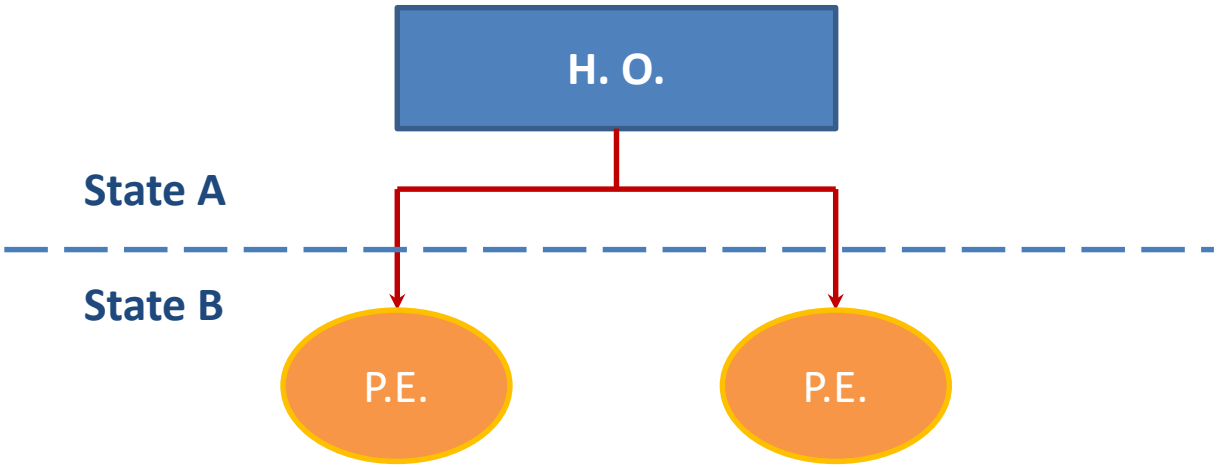
- Similarities from an economic, accounting and financial point of view, making the choice no critical issue from this perspective.
- In this respect, from a practical point of view differences these systems **relate more to terminology for basic concepts** to both systems and how much taxation is imposed.
- The essential PSC characteristic is that of the State ownership of the resources. The contractor receives a share of production.
- A debated advantage of PSCs is that they **permit the conditions governing petroleum exploration and development to be consolidated in one document**. This may be particularly helpful since the necessary provisions (including fiscal stabilization) can be consolidated in the PSC and the way in which the law will be applied can be clarified. However, some countries prefer to provide references to the general tax system, providing more flexibility but introducing uncertainty.
- In addition, PSC is a way in which **contractual assurances** can be offered to investors, however may lead to more administrative complexity.

Ring Fencing

- Ring fencing means a **limitation on consolidation of income and deductions for tax purposes** across different activities, or different projects, undertaken by the same taxpayer.
- Ring-fencing rules matter for **two main reasons**:
  - Absence of ring fencing can **postpone government tax revenue** because a company that undertakes a series of projects will be able to deduct exploration or development expenditures from each new project against the income of projects that are already generating taxable income.
  - As an oil and gas area matures, **absence of ring fencing may discriminate against new entrants** that have no income against which to deduct exploration or development expenditures.
- Despite these points, a very restrictive ring-fence is not necessarily in the government's interest. More exploration and development activities may occur if taxpayers can obtain a deduction against current income, generating more government revenue over time by increasing the taxable base.
- For example, in come cases, for tax purposes, the deductibility of the expenses of an abandoned block is allowed with the income of blocks that are in production (sometimes with a limitation on the expenses incurred in the failed block).
- The right choice is a **matter of balance within the fiscal regime**, the degree of government's preference for (modest) early revenues over (greater) revenues later.

Relation with Permanent Establishments

- **A PE per PSC**
- In order to have a single place of business both **geographical and commercial coherence** is required.
- The geographical and commercial coherence is normally defined by **each of the contractual areas** where oil and gas companies perform their activities through different joint ventures within a country.
- Under domestic law of certain countries, it is **not allowed that one entity signs more than one PSC**.
- Legal title by means of a **Production Sharing Contract** over a contractual area (geographic element) which is normally governed by several partners under a JOA managed through a consortium (commercial element) leads to a PE. Accordingly, when a contractor has entitlements to more than one contractual area in a country, it is considered that it has more than one PE within that country.



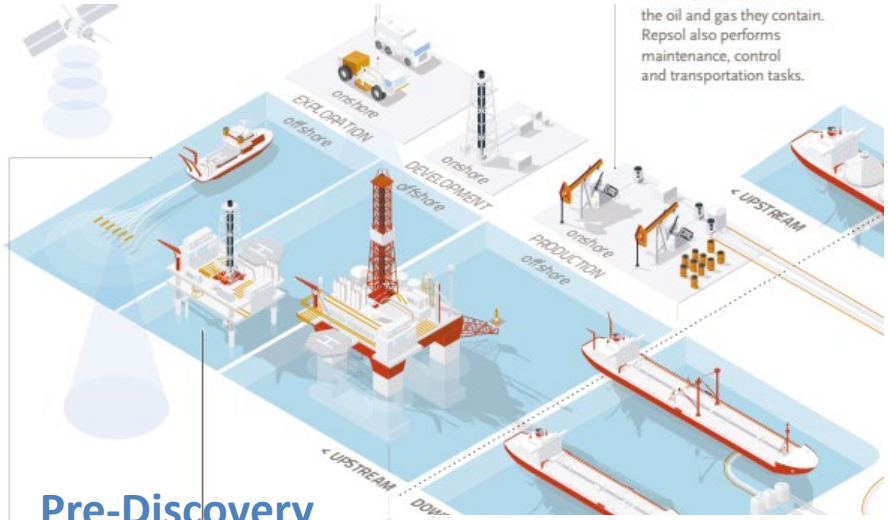
Joint Ventures

- **Joint Ventures**
  - Joint Ventures are a **common mode of doing business** in the international oil industry.
  - Contractors seek partners for large-scale and/or high risks ventures in order to **diversify risks**.
  - These joint operations differ from the government-contractor relationship, normally referred to as **government participation**.
- **Government participation**
  - Many governments have opted for **State participation in petroleum joint ventures (JVs)** via an option for the National Oil Company (NOC) to participate in development projects.
  - Under most PSC, the contractor bears the risk of exploration. If no O&G is found, the contractor cannot seek reimbursement of the cost incurred. If there is a discovery, the government **backs-in for a percentage** *("the government is carried through exploration"*) and may or may not reimburse the contractor for past exploration costs.
  - The government´s contribution to capital and operation costs is normally **paid out of production**.
  - **Government taking equity in the project can take several forms**, including: (i) a full working interest, which places the government on a par with a private investor; (ii) paid-up equity on concessional terms, where the government acquires its equity share at a below-market price, possibly being able to buy into the project after a commercial discovery has been made; (iii) a carried interest, where government pays for its equity share out of production proceeds, including an interest charge; etc.
  - Like all JV partners, the **NOC has the right to audit costs charged by the operator**.

Forms of Production Sharing

Production Sharing	
Daily Rate of Production (DROP)	Government share of profit petroleum increases with the daily rate of production from the field. Weaknesses are that field size is often a poor proxy for profitability and the mechanism is not progressive with respect to oil prices or costs. Attempts have been made to blend this with a scale of prices.
Cumulative production from project	Government share of profit petroleum as total cumulative production increases—again an inaccurate proxy for the contractor's rate of return. Such schemes are becoming rarer.
'R-Factor'	Government's profit share increases with the ratio of contractor's cumulative revenues to contractor's cumulative costs (the 'R factor'). This improves on DROP in being a more direct measure of profitability, but does not recognize the time value of money
Rate of Return (ROR)	This is a form of rent tax (provided that exploration is part of costs) under which the government's share is set by reference to the cumulative contractor rate of return, no tax being levied if that falls short of some benchmark rate. Single or multiple tiers are used, though staff analysis suggests a single tier is effective.

Tax Base Spectrum



- PSC regimes aim is to establish a balance between the host country take and the contractor take.

Government take

Contractor´s take

Signature

Pre-Discovery

Exploration
It all starts with the identification and acquisition of a new average. We then proceed with geology and geophysics tasks, environmental impact studies, exploratory and appraisal wells, defining the resources discovered and establishing the marketability of the hydrocarbons discovered.

Development
If the outcome of exploration tasks is positive, production wells are drilled a

Post - Discovery

- Signature Bonus
- Rentals

Gross Revenue
- Production Bonus
- Royalties

Profit Oil Split

Gross-up

Net Revenue
- Income Tax
- Windfall Profit Tax

E&P costs (Recoverable Cost)

Cost Recovery (Limited)

Operating Costs

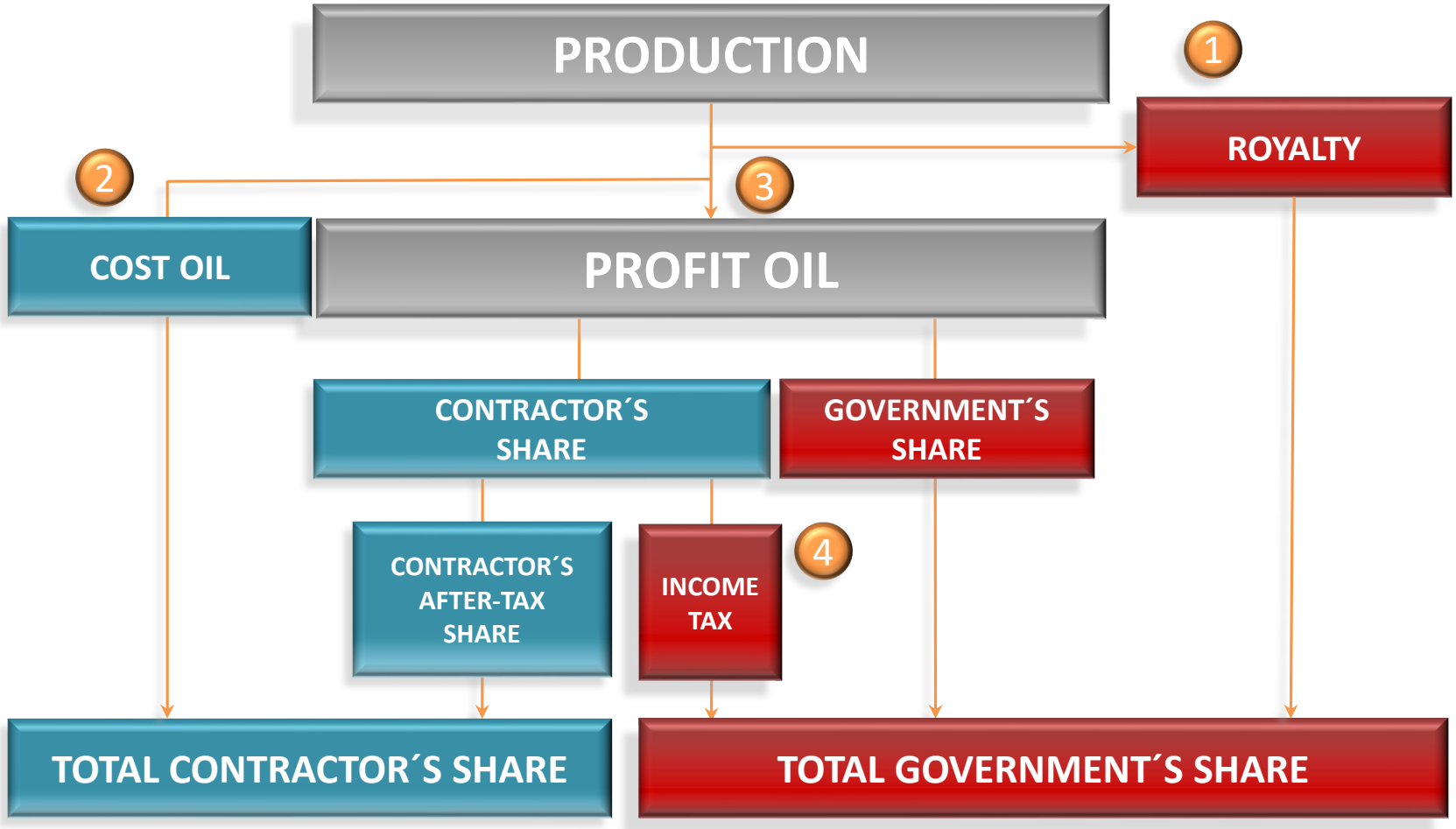
Abandonment Costs

CAPEX+OPEX CAN AMOUNT ~50% OF GROSS PETROLEUM REVENUES

Contractor operates at sole risk.

Government Participation

PSC Revenue Flow



2 **Cost Oil**: share of total production, which can be retained by the contractor to recover costs incurred, normally subject to a maximum amount (cost oil limit).

3 **Profit Oil**: share of remaining oil after cost recovery. Profit oil is divided between the government and the contractor according to some formula set out in the PSC.

Work Commitments I

- **Minimum work obligations in Exploration Phase**.
- Specified in terms of kilometers of **seismic data** and number of **wells** to be drilled.
  - Seismic work may constitute the only work in least explored (frontier) areas,
  - May consist of seismic data acquisition with an option to drill exploration wells.
  - Acquire and interpret certain seismic required to drill a number of wells.
- Sometimes a **minimum expenditure level** is required in the work commitment.
- The terms of the work commitment outline **indemnities** for non-performance.
- Sensitive aspect for exploration activities (embodies most of the risk).

EXAMPLE. EXCERPT FROM THE EQUATORIAL GUINEA MODEL PSA (1):

(a) obtain...all existing 2D and 3D seismic data and Well data at a purchase price of [___] Dollars ($[___])...and the Contractor shall undertake to interpret such information;

(b) reprocess [____] km. of existing 2D seismic data and [___] km. of 3D seismic data; and

(c) acquire [____] kilometers of new 3D seismic data.

During the Second Exploration Sub-Period, the Contractor must drill a minimum of [___] Exploration Well[s] to a minimum depth of [_____] meters below the seabed. The minimum expenditure for this period shall be [___] Dollars ($[____]).

(1) http://www.eisourcebook.org/cms/files/attachments/other/Equatorial%20Guinea%20Model%20Production%20Sharing%20Contract.pdf

Work Commitments II

EXAMPLE. EXCERPT FROM THE INDIA MODEL PSA 2005 ([1]):

During the currency of the first Exploration Phase…, the Contractor shall complete the following Work Programme:

(a) a seismic programme consisting of the acquisition, processing and interpretation of [____] line kilometres of 2D and/or [____] sq. kms. of 3D seismic data in relation to the exploration objectives; and (b) [__]Exploration Wells shall be drilled to at least one of the following depths : i) [__] metres and [___] (geological objective); ii) to Basement; and iii) that point below which further drilling becomes impracticable due to geological conditions encountered and drilling would be abandoned by a reasonable prudent operator in the same or similar circumstances. Abandonment of drilling under this provision by the Contractor, would require unanimous approval of the Management Committee.

(1) http://petroleum.nic.in/sites/default/files/MPSC%20NELP-V.pdf

Domestic Market Obligation

- Many PSC requires the contractor to **set aside a portion of its share of production for delivery to the local market**. This requirement is referred to as domestic market obligation (DMO).
- Usually the **price** that the Contractor can charge for the oil is at a discount to world prices (occasionally the contract establishes a maximum price that may be below the market price that the Contractor could have received if the domestic market obligation had not existed. The government may also pay for the domestic crude in local currency at a predetermined exchange rate.
- Revenues from sale of domestic oil are **normally taxable**.

EXAMPLE:

After commercial production commences, fulfil its obligation towards the supply of domestic market. ***CONTRACTOR agrees to sell and deliver to the Government of _____ a portion of the share of Crude Oil****, (…), calculated for each year as follows:*

(a) Compute [X] per cent of CONTRACTOR´s entitlement (…) multiplied by total quantity of Oil produced from the Contract Area;

(b) The price at which such Oil be delivered and sold (…) shall be [X] per cent of the price determined under Sub-section (…), and CONTRACTOR shall not be obligated to transport such Oil beyond the Point of Export, but upon request CONTRACTOR shall assist in arranging transportation and such assistance shall be without cost or risk to CONTRACTOR.

Bonuses I

Signature Bonus	Payment made by the contractor to the government at the time that the petroleum contract is granted. It may be determined through a bidding process, negotiation, or set by legislation.
Development Bonus	A relative smaller sum of money is paid at the signing of the contract with subsequent payments being made if and when production reaches a specified level.
Production Bonus	Payment made at a certain point in time during the life of the petroleum contract. May occur at the time that a commercial discovery is declared, at the time that petroleum production begins, at a defined production rate or at a defined quantity of cumulative production.

EXAMPLE. EXCERPT FROM THE LIBYA MODEL PSA ([1]):

Signature bonus: as a signature bonus, a lump sum amount of …… US Dollars (US$ ……);

Production bonus: (a) an amount of one million US Dollars (US $1,000,000) to be paid in respect of each Commercial Discovery within thirty (30) days after Commercial Production Start Date of such Commercial Discovery; and (b) an amount of five million US Dollars (US $5,000,000) upon achieving cumulative production of one hundred million (100,000,000) Barrels of oil equivalent from each Commercial Discovery and thereafter, an amount of three million US Dollars (US $3,000,000) upon achieving each additional thirty million (30,000,000) barrels of oil equivalent.

(1) http://www.eisourcebook.org/cms/files/attachments/other/Equatorial%20Guinea%20Model%20Production%20Sharing%20Contract.pdf

Bonus II

EXAMPLE: EXCERPT FROM THE KURDISTAN (IRAK) MODEL PSA ([1]):

Production bonus:

- *[X] Dollars when average production of Crude Oil from a Production Area first reaches [X] barrels per day for a period of ninety (90) consecutive days.*
- *[X] Dollars when average production of Crude Oil from a Production Area first reaches [X] barrels per day for a period of ninety (90) consecutive days.*

In the event of a Natural Gas Discovery, the calorific equivalent value of the above mentioned production rates shall be applied to determine any production bonus to be paid.

(1) http://cabinet.gov.krd/pdf/MODEL_PRODUCTION_SHARING_AND_EXPLORATION_PRODUCTION_IN_KURDISTAN.pdf

❑ Bonuses can be **not recoverable / recoverable**, and/or **non deductible / deductible**. **EXAMPLES:**

Country	Bonus Treatment
Malaysia	Signature bonuses to be paid are cost recoverable, and for tax purposes are qualifying exploration expenditure tax deductible under Initial Allowance of 10% and Annual Allowance of 15% or calculation based on a formula, whichever is the greater.
Vietnam:	Non recoverable / tax deductible
Indonesia:	Non recoverable / non tax deductible

Rentals

- Fixed payment made on an annual basis, normally at the beginning of the calendar year or contract year.
  - May take on different forms: it could be a fixed amount for the contract, or fixed amount per square km. of operations land, the "object value" or a negotiated amount.
  - The basis for charging may vary between exploration/exploitation phase and/or onshore and offshore.
  - It may be payable depending on the territorial zone in which operations are carried out (e.g. Algeria).
- Recoverable cost / deductible.
- Provides government regular income and encourages voluntary relinquishment of acreage.
- Issues regarding the delimitation of the "area":
  - **EXAMPLE. INDONESIA LAND AND BUILDING TAX (PBB):**
    - 0,5% of a "deemed" tax base (ranges from 20% up to 100% of the "object value", being a statutory value).
    - Change in 2013 provided for post GR 79 PSC to self-remit the tax and claim it as cost recovery (instead of "overbooking"),

2013

      - This change become a concern as most post GR 79 PSC were still in exploration phase (uncertainty of cost recovery),
      - DGT issued clarification for the "offshore" component of objects to specify that only apply to the area "utilized",
      - The term "utilized" was not defined, but the intend appeared to be to reduce tax exposure for theses PSCs.
      - Latter, the DGT issue new compliance and calculation procedures for PSC, which:
        - ✓ The definition of "offshore area" did not refer to "utilization", giving rise to uncertainty.
        - ✓ Introduces a "zone" concept, which could include areas outside the PSC contract area (total area?).
    - Under clarification by tax authorities based on distinction between surface working area and subsurface reservoir area.

Royalties

- Royalties are based on the volume or value of petroleum extracted, paid in cash or in kind.
- Royalties are paid as soon as commercial production commences, providing early revenue to the government.
- Royalties are taken right off the top of gross revenues (i.e. without deduction of any costs).

TYPE OF ROYALTIES		
Fixed Percentage	Of Production (e.g. 10% of oil extracted).	Easy to administer, but do not take into account the profitability of the project (regressive).
Sliding Scales	• Level of field Production, • Level of well Production, • Level of well Production and Price, • Cumulative Production, • Based on payout, • Based on Internal Rate of Return, • Based on gravity of oil, • Based on elapsed time • Etc.	The rationale is that larger production levels lead to greater profitability.

- **Determination point**: wellhead, block boundary, export terminal, point of sale, etc. (*netback transportation cost*).
- **Exclusions**: O&G vented or flared (with approval), reinjected, used in field operations, acceptable losses, etc.
- **Local market obligation**: e.g. a percentage of the contractors oil to be sold at a special market price.

Sliding Scale Royalties I

- Used to escalate the royalty based on a factor that tends to predict the profitability of a project.
- Production levels are a proxy for profitability, but there are other factors (e.g. prices, costs, timing, etc.).
- Some countries have designed the royalty rate to depend on the **"R factor"** ("R" stands for "ratio").
- A common "R factor" is the ratio of **cumulative receipts from the sale of petroleum to cumulative expenditures.**

$$R = \frac{\text{Cumulative Revenues } (1)}{\text{Cumulative expenditures } (2)}$$

- This ratio is initially zero during exploration as there is no sale of petroleum while there may be considerable expenses and gradually grows in time.
- An **R-factor less than 1** would mean that costs have not been fully recovered yet (total expenditures exceed total receipts). At payout, the R-fact is equal to 1. The larger the R-factor, the more profitable the operation.
- The royalty rate or the government's share of production may increase with increasing R-factor.
- **Sliding Scales can be used with respect to Profit Oil or Gas splits and Taxes or Profit Shares.**

(1) Cumulative net revenue actually received by the contractor for all tax years less taxes paid.

(2) Cumulative expenditure, exploration and appraisal expenses and operating costs actually incurred by the contractor from the date the contract is signed.

Sliding Scale Royalties II

EXAMPLE. ALGERIA: The rate is determined in each contract. However, the law has fixed a minimum rate per area ([1]):

Production (BOE) / Area	A	B	C	D
0-20,000 BOE/day	5.5%	8.0%	11.0%	12.5%
20,001-50,000 BOE/day	10.5%	13.0%	16.0%	20.%
50,001-100,000 BOE/day	15.5%	18.0%	20.0%	23.0%
> 100,000 BOE/day	12.0%	14.5%	17.0%	20.0%

EXAMPLE: THAILAND III REGIME: If the royalty is paid in cash, the following sliding scale applies ([1]):

Monthly sales volume	Rate %
0-60,000 barrels	5.00
60,001-150,000 barrels	6.25
150,001-300,000 barrels	10.00
300,001-600,000 barrels	12.50
> 600,000 barrels	15.00

A deep-sea, offshore exploration block (deeper than 200 meters) is subject to only 70% of the royalty that would otherwise be payable according to the table.

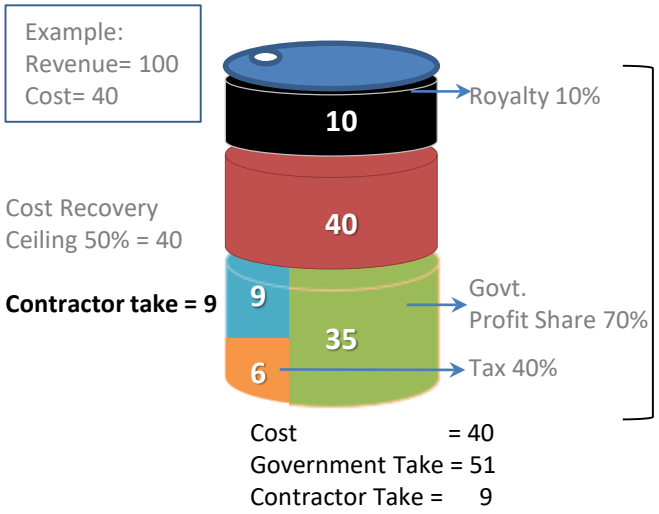
(1) EY O&G tax guide 2018: https://www.ey.com/Publication/vwLUAssets/ey-global-oil-and-gas-tax-guide/$FILE/ey-global-oil-and-gas-tax-guide.pdf

Profit Sharing I

- **PSCs include a fiscal tool that defines some of the production as "Profit Oil/Gas" and shares it between the State and Contractor.**
- **COST OIL**
  - **Oil retained by the contractor to recover the costs of exploration, development and production**. Most PSCs limit the amount of cost oil that can be retained in a given accounting period (the effect is that the State receives its share of profit as soon as production .
  - Costs that are not recovered are **carried forward** and recovered later; most PSCs allow virtually unlimited carry forward. It is another avenue available to the government to ensure early revenue (considered less regressive than royalties).
  - The PSC specifies which **costs are eligible for cost recovery**. Usually, these include unrecovered costs carried from previous years, operating expenditures (OPEX), capital expenditures (CAPEX) and abandonment costs.
  - **Expenses not eligible for cost recovery** may include (depending on government´s policy) bonuses, royalties; interest or other financing related payments and overheads beyond specified limits; and costs outside the budget (unless approved by government).
- **PROFIT OIL**
  - **Share of production remaining after royalty is paid and cost oil has been delivered to the contractor,** paid in cash or in kind (*).
  - In its simplest formulation, a fix profit oil share can apply. E.g.: 50% in the Thailand-Malaysia Joint Development Area.
  - Production sharing can also be on a **sliding scale**: the percent share of the government can increase with, amongst others, the level of field production, cumulative production, combination of field and cumulative production, R-factor, or rate of return.
- A cost recovery limit with a profit oil split ensures that in each accounting period the **government will get a share of production**.

(*) Please Note Indonesian Government released a new O&G gross split regime in 2017 which coexists with the current cost recovery regime.

Profit Sharing II



Government Take: 51

Contractor share	Gross Revenue 100	Government share
	Royalty (10%)	
	90	10
	Cost Recovery	
40	50% limit	
(Asumed cost)	50	
	Profit Oil Split	
Gross Revenue 15	30%/70%	35
Tax 40%		6
(After-tax) 9		51

- The profit oil (or profit gas) split between the host government and the investor is often **negotiable**. Contractual PSC of liquid and gaseous hydrocarbons are different, with the terms of production of gas are normally more beneficial for the contractor.
- Some PSC allows the contractor for ***uplifts*** (recover additional percentage of capital costs through cost recovery or a compensation received by a Contractor that relates to providing advanced funds for financing).
- Some PSC attempt to achieve fiscal stability by allocating tax and royalty payments to the government share.
- In general, profit oil split around the world has a **sliding scale** of some sort. The usual approach is an incremental sliding scale based upon average daily production.
- The ultimate objective of a PSC system is to create a framework that:
  - fulfils the mutual interest between the host government and the contractor, and
  - Provides an equitable arrangement bot both highly profitable and less profitable *commercial* discoveries (*).

(*) An important aspect of exploration, as determines whether a discovery is economically feasible and should be developed.

Interaction with other Tax Instruments

- PSC and **royalties** payable
  a) Could form part of **cost oil** and be recovered by the contractor.
  b) Could be payable by the contractor **before profit oil** is allocated.
  c) Could be **payable by the State from its share of profit oil**.
- PSC and **corporate income tax**
  a) The tax liability is effectively paid by the State from its profit oil. In practice a **grossed up amount** is paid in the name of and on behalf of the contractor in order to settle the tax payable by the contractor on taxable income on its hydrocarbon activities including the payment received from the State in respect of income tax.
  b) Tax is calculated **based on PSC item**s and is effectively a percentage of the contractor's profit oil.
  c) Tax is calculated according to **normal income tax rules**.
- Rules on the **ownership of assets** under a PSC would impact on the extent of deductible depreciation/capital allowances by contractors for income tax.
- Unless otherwise specified in the contract, the State is typically responsible for the cost of **decommissioning**.

Sources of Information

- Examining the Crude Details Government Audits of Oil & Gas Project Costs to Maximize Revenue Collection (Oxfam November 2018). https://www.oxfam.org/en/research/examining-crude-details
- E. Sunley et al., Revenue from the Oil and Gas Sector: Issues and Country Experience (Washington, DC: IMF, 2002), http://siteresources.worldbank.org/INTTPA/Resources/SunleyPaper.pdf
- Daniel Johnston, International Petroleum Fiscal Systems and Production Sharing Contracts, (PennWell Books, Tulsa, Oklahoma,1994).
- Daniel Johnston, International Exploration Economics, Risk, and Contract Analysis, (PennWell Books, Tulsa, Oklahoma, 2003).
- Charlotte J. Wright, Rebecca A. Gallun, International Petroleum Accounting (PenWell Books, Tulsa, Oklahoma, 2005)
- WoodMackenzie, Pinsent Masons, Indonesia´s new Gross Split PSC https://www.pinsentmasons.com/PDF/2017/Asia%20Pacific/Indonesias-new-Gross-Split-PSC.pdf
- Emil M. Sunley, Thomas Baunsgaard and Dominique Simard, Revenue from the Oil and Gas Sector: Issues and Country Experience http://siteresources.worldbank.org/INTTPA/Resources/SunleyPaper.pdf
- IMF, Fiscal Regimes for Extractive Industries: Design and Implementation (15 August 2012). https://www.imf.org/external/np/pp/eng/2012/081512.pdf
- Jones Day, Indonesia's New Gross Split Production Sharing Contracts for the Oil & Gas Industry https://www.jonesday.com/Indonesias-New-Gross-Split-Production-Sharing-Contracts-for-the-Oil--Gas-Industry-02-03-2017/#

Annex 3: Production Sharing Agreements (PSC)

1. Fiscal System Taxonomy

A. Concessionary and Contractual regimes

- Tax/Royalty
- Production Sharing Agreements
- Service contracts

B. Choice between Tax/Royalty and PSC

2. Production Sharing Contracts

A. Origin of PSC

B. Design of a PSC fiscal System

- Parties to a PSC
- Ring Fencing
- Relation with Permanent Establishments
- Joint Ventures
- Forms of Production Sharing

3. Features of a Production Sharing Contract

A. General Features

- Tax Base Spectrum
- B. PSC Revenue Flow
- C. Work Commitments
- D. Domestic Market Obligation

B. General Features

- Bonuses
- Rentals (Land, Surface tax)
- Royalties
- Profit Sharing
- Interaction with other Tax Instruments

4. Sources of Information

(Annex 4)
Tax Treatment of Financial Transaction in the Extractive Industries

Financing in the Oil&Gas (O&G) sector

DRAFT FOR DISCUSSION

United Nations, April 2019

Introduction

- Oil & Gas companies permanently keeps evaluating large broad band of projects in term of:
  - ✓ Synergies between Upstream and Downstream.
  - ✓ Risks, which is an important factor in the Oil & Gas industry.
  - ✓ Return on capital employed.
  - ✓ Financing structure.

Capital Investment needs & decisions

- **Country/political Risks**
  - **Investment Risks**:
    - ✓ Currency convertibility and transfer: devaluation, exchange controls, default.
    - ✓ Expropriation: seizure by the government without payment of just compensation. Investment Protection Agreements.
    - ✓ Political Violence (i.e. war and civil disturbance – also know as *force majeure*).
  - **Change of law Risks**:
  - Wide risk that needs to be consider for any project, wherever it is located.
    - ✓ Stable legal and regulatory environment.
  - **Quasi-political risks**:
    - ✓ Breach of contract by contracting authority (commercial dispute or refusal by the government to honor obligation),
    - ✓ Arbitrary behavior by the authorities or courts.
- **Investment Returns**
  - **Net Present Value**
    - ✓ The value today of a sum of money due in the future, taking account of the cost of money, know as the discount rate.
  - **Internal Rate of Return**
    - ✓ Measures the return on the investment over its life. It is the discount rate at which the NPV of the cash flow is zero.

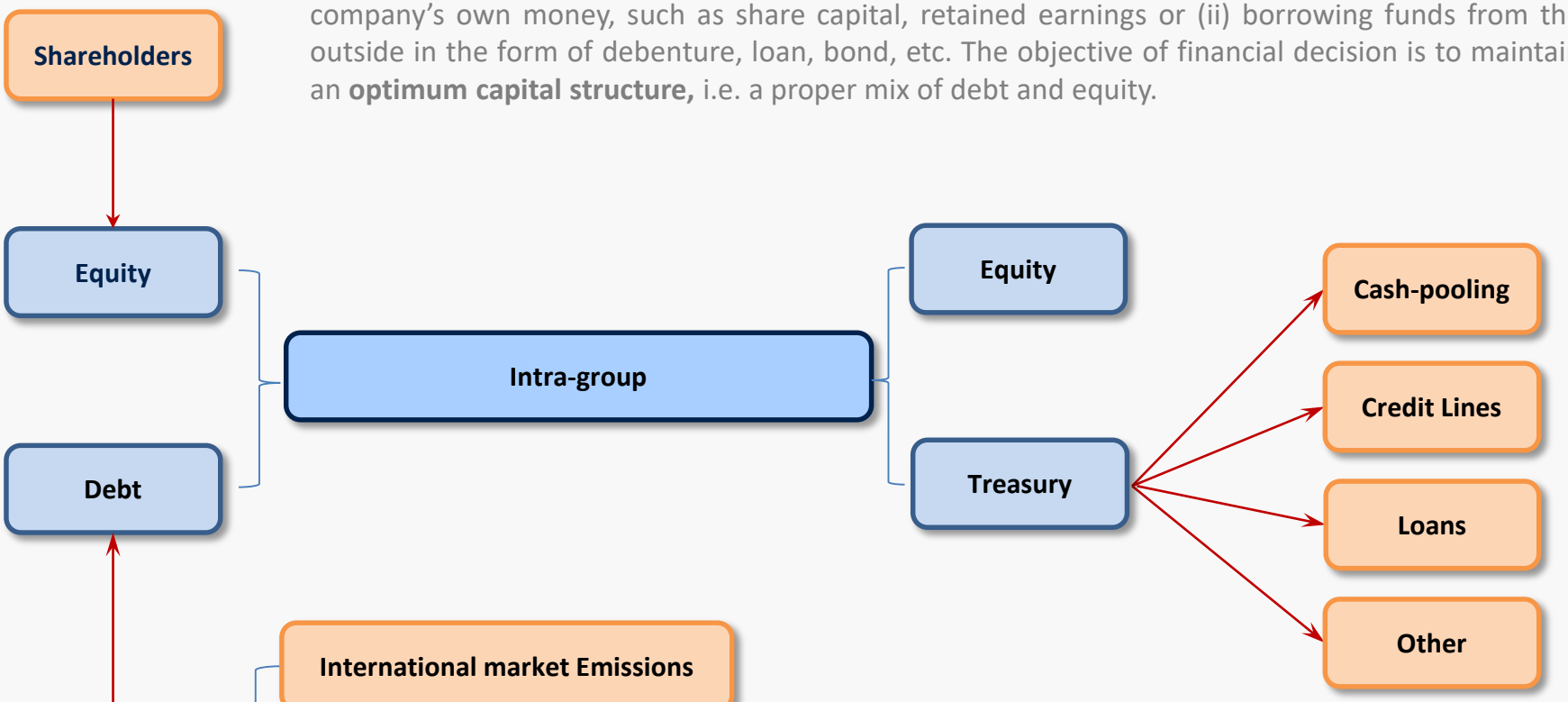
Traditional Sources of Financing

- A company should make a judicious decision regarding how the funds shall be raised, since:
  - Increase use of **Equity** results in the dilution of ownership and,
  - Higher **Debt** results in higher risk, as fixed cost in the form of interest is to be paid on the borrowed funds.
  - More complex finance structures using **Mezzanine** may lead to legal uncertainty and disputes.

Option	Benefits	Challenges
Equity	▪ Allows full control. ▪ Requires strong balance sheet. ▪ Long term. ▪ No cost to external parties. ▪ Returns invested in business/returned to shareholders.	▪ Difficult to raise. ▪ Dilution problems. ▪ Expensive –cost of capital
Debt (Loans)	▪ Flexible source of short-term debt. ▪ Flexibility in reduction and repayment.	▪ Capacity constrained except for large, preferred borrowers or short-term borrowers. ▪ High cost of funds make heavily bank funded projects virtually unprofitable.
Mezzanine Finance	▪ Provides alternative hybrid of debt/equity. ▪ Flexibility in reduction and repayment structures.	▪ Security required in most cases. ▪ Complex in structuring. ▪ Complex disclosure and due diligence requirements.

Capital/Debt

- The financing decision involves two sources from where the funds can be raised: (i) using a company's own money, such as share capital, retained earnings or (ii) borrowing funds from the outside in the form of debenture, loan, bond, etc. The objective of financial decision is to maintain an **optimum capital structure,** i.e. a proper mix of debt and equity.



Sources of Finance

CAPITAL
Shareholder contributions

- **Pure Capital**
- **Shareholder´s loan**

DEBT
External Financing

- **International/Local Banks**
  - Syndicate
  - Club Deal
- **Multilateral**

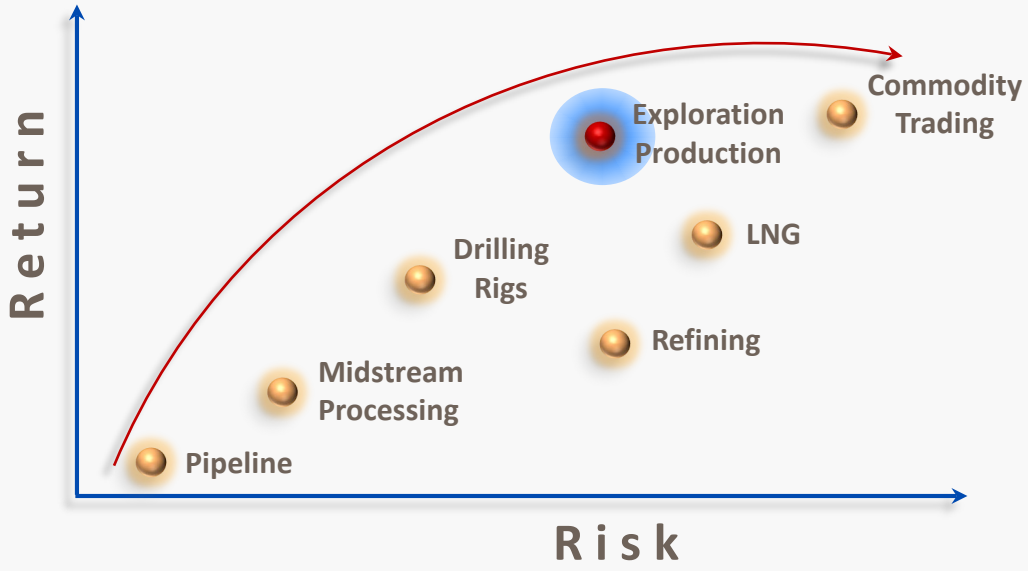
Supranational Organisms

  - International Finance Corporation (IFC)
  - European Investment Bank (EIB)
  - Banco Interamericano de Desarrollo (BID)
  - Asian Development Bank (ADB)
- **Export Credit Agencies**
  - CESCE (Spain)
  - SACE (Italy)
  - US EXIM (USA)
  - JBIC (Japan)
- **Capital Markets (Bonds)**
  - Local
  - International

- **International/Local Bank**
  - **Syndicated loan**: financing offered by a group of lenders (syndicate) who work together to provide funds for a single borrower.
  - **Club Deal**: is a transaction where a number of private equity groups provide capital for the acquisition of a target that is larger than any one party could execute on their own.
- **Export Credit Agencies:** institutions that act as an intermediary between national governments and exporters to issue export financing following OECD rules.

Financing in the Extractive Industry

- Characterized by two factors since its inception: an extraordinary high degree of risk and a constant hunger for capital ([1]).
- Each investment is different from a Risk-Return standpoint:

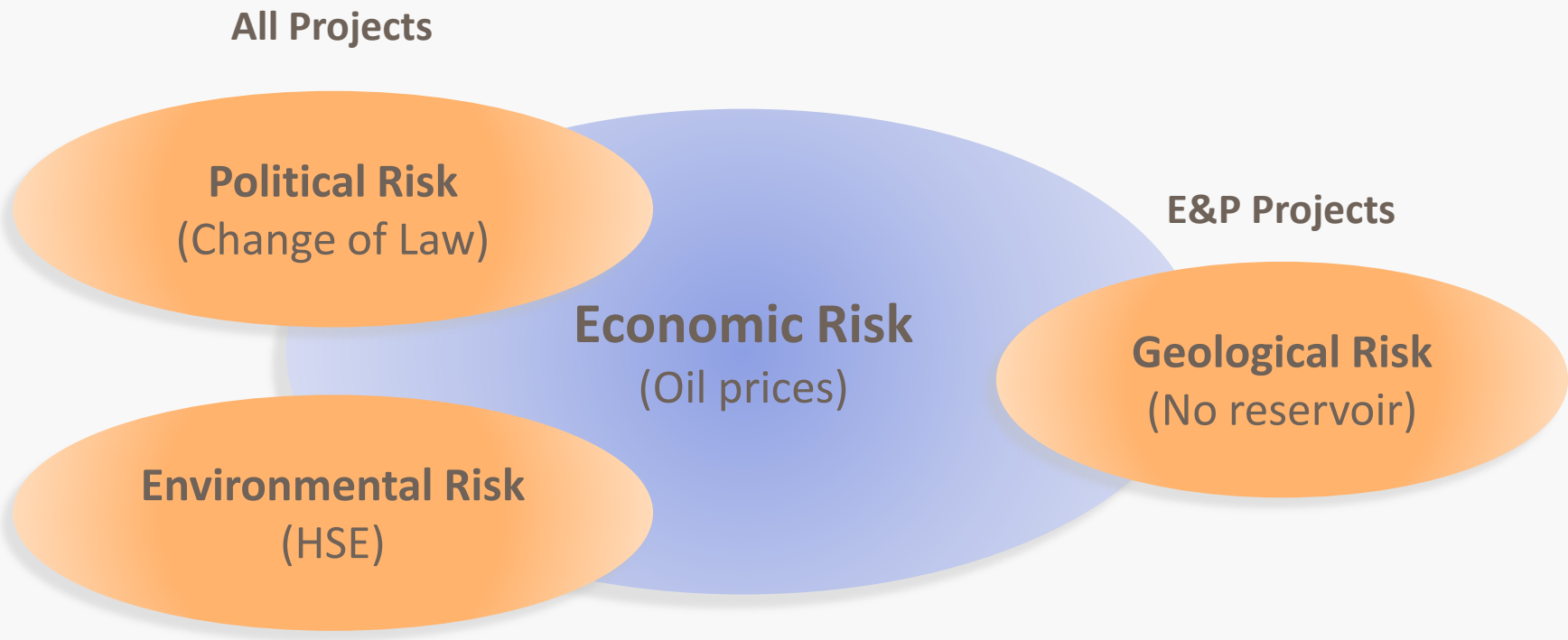


Source: EKT Interactive. (2014) “Managing Risk in Oil and Gas”.

(1) Norman A. White and Albert W. Angulo et. al. (1978) Financing the International Petroleum Industry. Chatham: Graham & Trotman Ltd. p.16.

Financing in the Extractive Industry

- All O&G projects have risks, E&P has more than others:

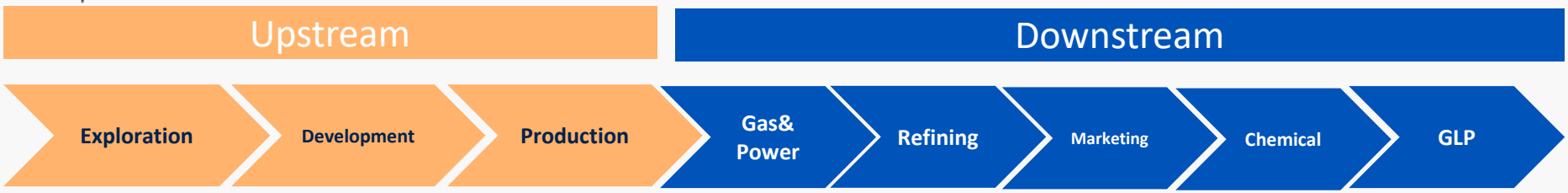


Financing in the Extractive Industry

- Capital Intensive Industry.

Segment	Capital Requirement	Time frame
▪ Exploration ▪ Production	High	▪ Exploration: 3-10 years ▪ Production: 50-60 years
▪ Refineries ▪ Gas Plants	Very High	50-80 years
▪ Marketing ▪ Transportation (vessels, pipelines)	Low-Medium	▪ Marketing: variable ▪ Transportation: 50-100 years

Supply Chain Financing in the Extractive Industry



Upstream

Risky, low predictability and capital intensive

- **Exploration is equity financed.**
  - Usually unable to borrow from external sources due to the high risk/capital involved.
- **Farm in/farm-outs:**
  - Exploration companies may bring in a new partner in exchange for a future spending commitment. The owner of a working interest (the farmor) seeks finance by exchanging a portion of its working interests to another party (the farmee) in return for the farmee´s performance of some agreed upon action. E.g.: the farmee may agree to undertake exploration of a property or drill a well(s). In return the farmor agrees to exchange a portion of the working interest.
- **External financing:**
  - When production begins, companies may seek external funding, including structuring finance.

Downstream

Stable and long-term cash flow generation.

- Project Finance
- ECA's,
- Multilaterals
- Project Bonds

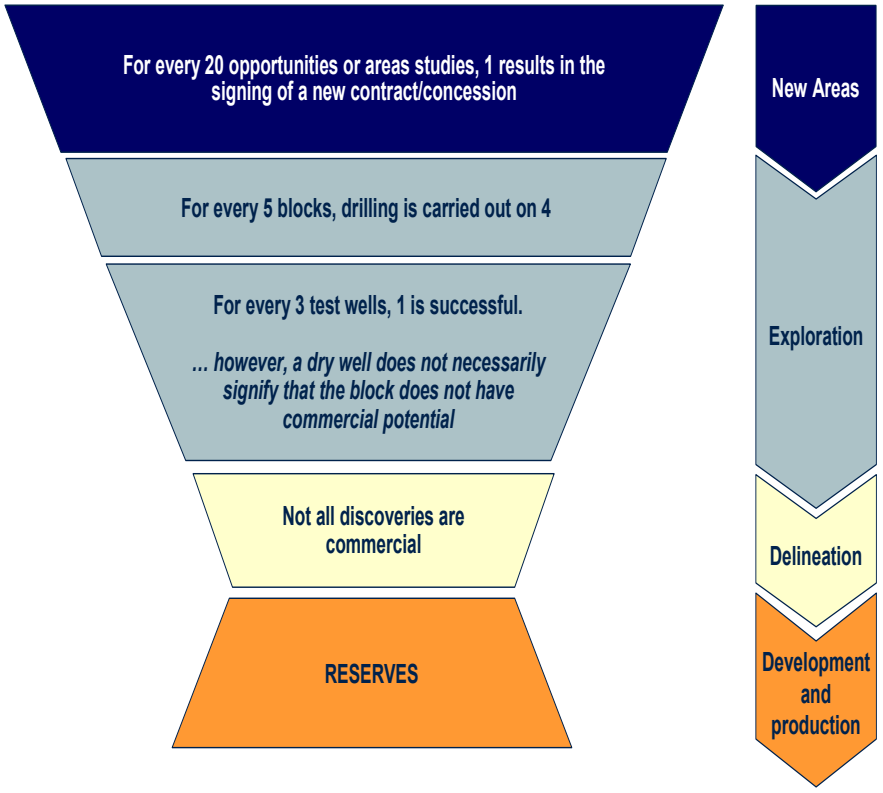
Shared Contracts.

- Typically two or more companies come together to fund the execution of a contract.
- Joint developments mitigates the risk of lost contracts.
- Usually requires structuring from the parties involved to avoid conflicts.

E&P Features: High risk activity

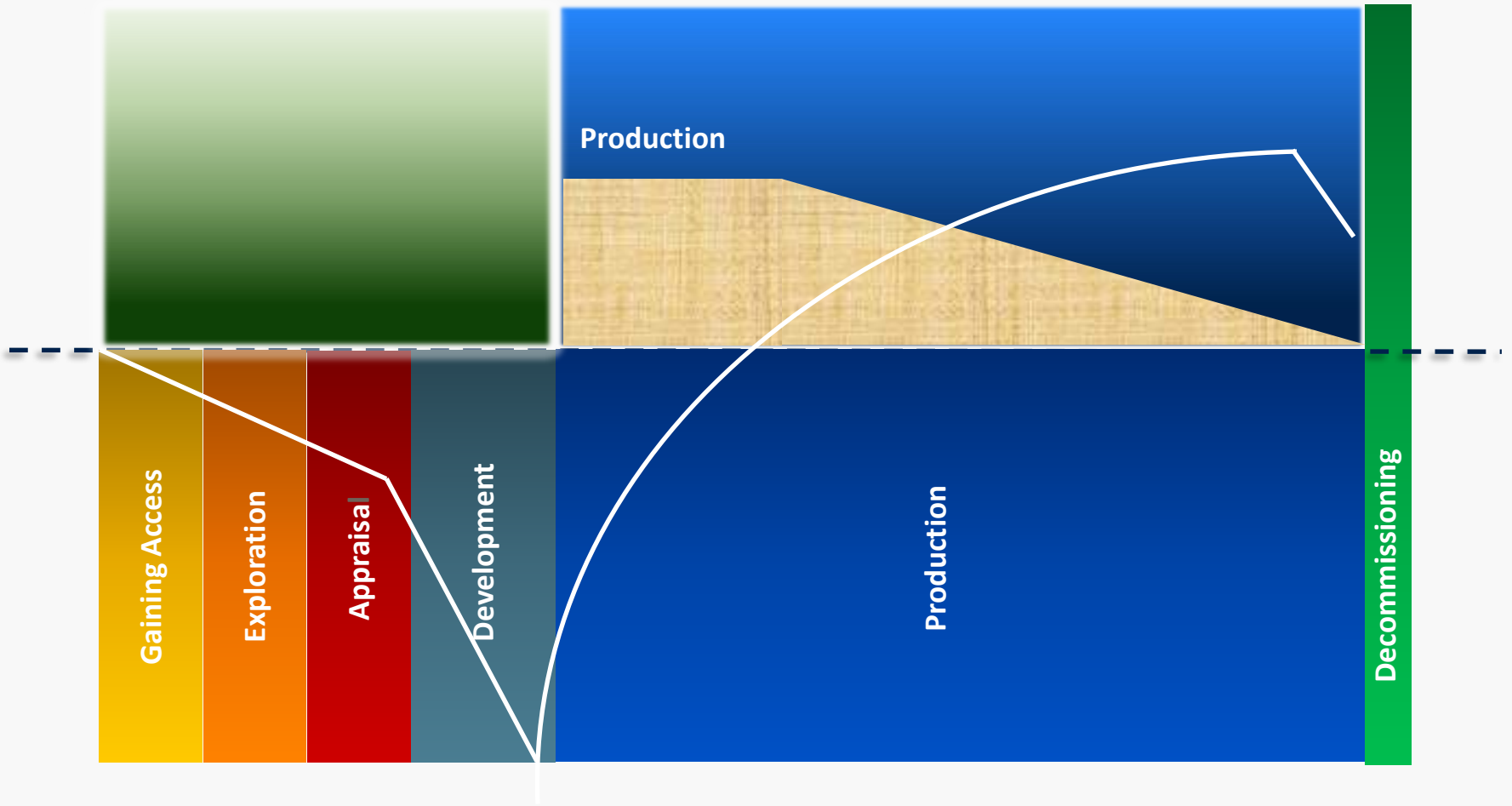
- **Upstream companies** need to replace their proven reserves to survive. Reserves are non-renewable resources, very difficult to find and sensitive to commodity prices.
- **Life cycle** of an extractive industry project has broad phases. The exploration and production (E&P) activities are the beginning stages of the life cycle and involve large upfront capital investment that carries **significant risks** in terms of achieving commercially successful results. Lead times from exploration through development to first production are long— often more than 10 years—further increasing project risks.
- Investors often seek to reduce risks via **project diversification**, normally in cooperation with other partners. The O&G industry is characterized by **joint ventures** (JVs) to reduce geological, geopolitical and other risks. JV partners can also include government bodies or NOCs.
- To sum up, upstream companies incur in considerable losses at the exploration stage.

ILLUSTRATION OF THE INHERENT RISK IN THE EXPLORATION PROCESS

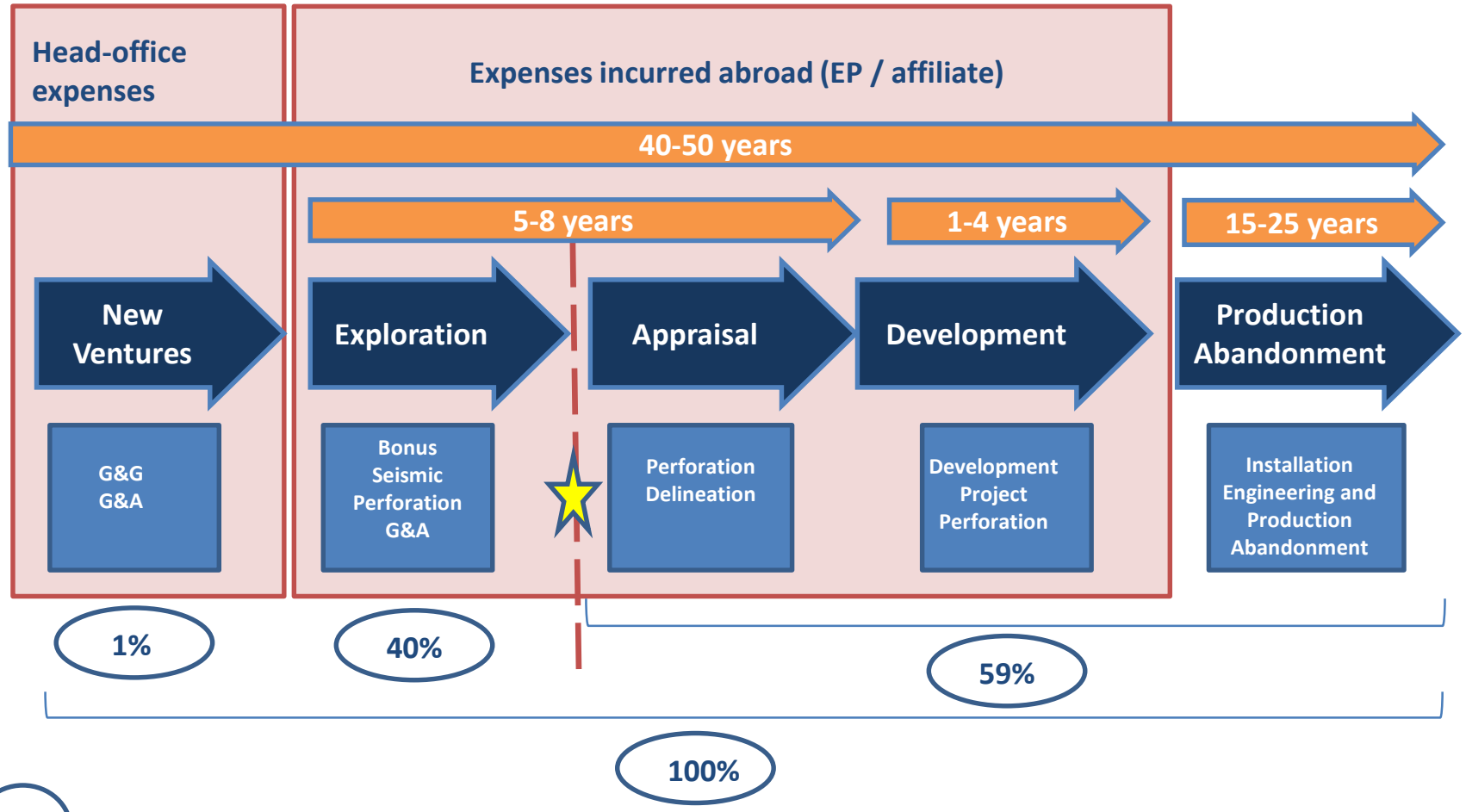


Field life cycle: cummulative cash flow

- Banks only lend against proven reserves or (sometimes) probable but not possible



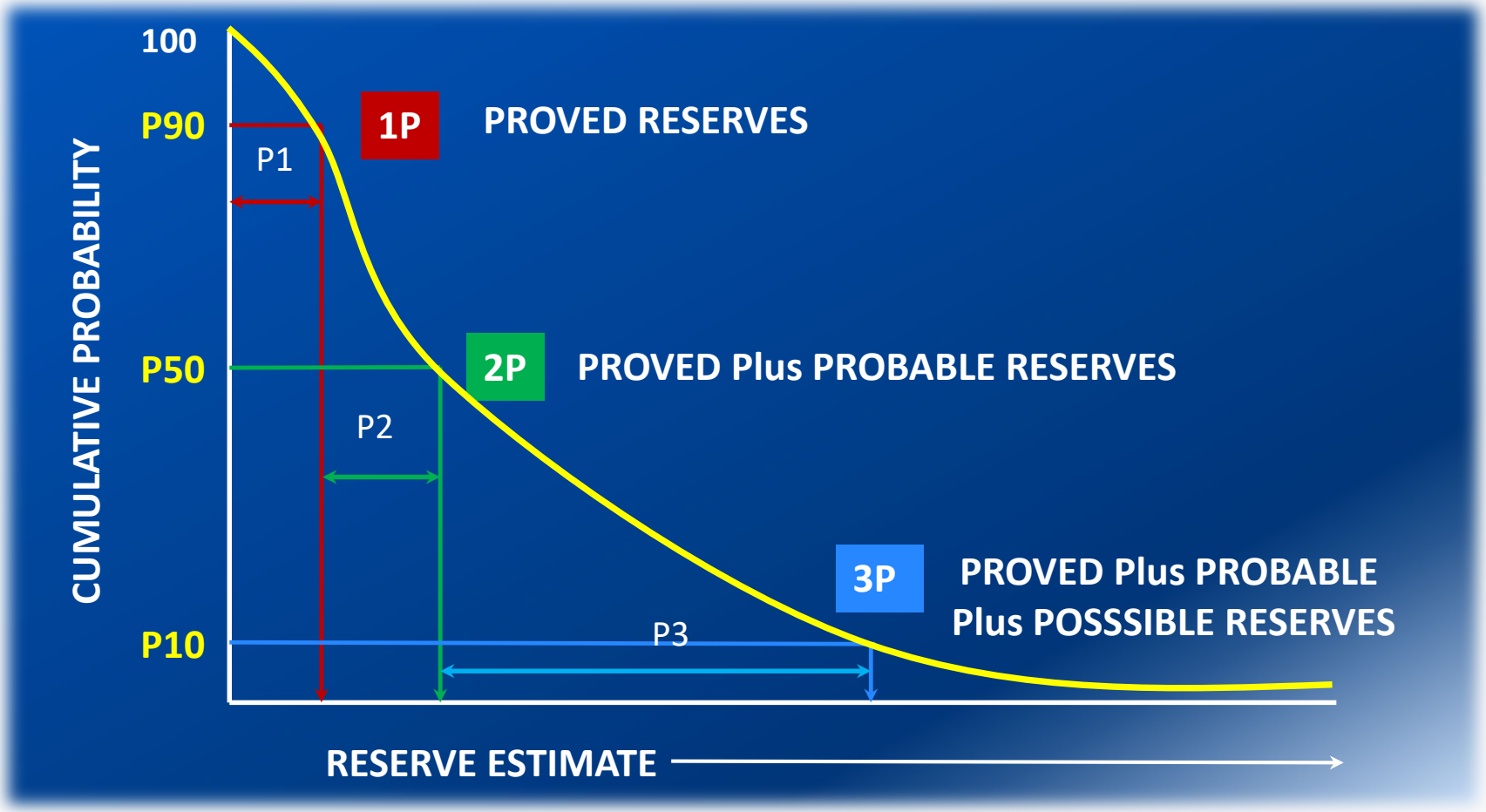
Upstream life cycle



Percentage of costs incurred at each of the different stages of the project (approximate rate).

In the event of *dry well* or non-commercial discovery, the project does not go ahead (final loss).

Reserve Booking Categories



P1: It is probable that 90% or more of the resource is recoverable while being economically profitable. P2: 50%, P3: 10%

Farm-in/ Farm-out

- **Grassroots exploration** normally entails lower entry costs, however companies may find difficulties obtaining a respectable international portfolio in a short term period if they only pursue this method.
- Typically, companies obtain exploration licenses and farm-out work commitments, getting *carried* through the wells.
- The type of interest owned by the O&G company after entering into the agreement is a working interest.
- Common farm-in/farm-out agreements are 2:1 or third-for-a quarter promote (with or without a cap).
  - **Example**: 45% WI to [A]. [A] will promote [a] well for 2:1, with a cost cap of 19,2 MUSD, in addition paying its share of the well cost. Same carry will apply to [b] well following a commercial discovery in [a] well.

	Total well investment:	**19,2 MUSD (100%)**	
Farmee	W.I. farmee:	8,64 MUSD (45%)	**90% of total cost (normally cost recoverable)**
	Total carry value (2:1):	8,64 MUSD	
	Cost of farmor:	1,92 MUSD	**10% of total cost**

- In areas where prospects are particularly lucrative, the carry may be higher.
- However, many deals have very low interest, with some deals referred to as ***ground floor*** where there is no *promote*.
- Many governments understand the marketplace as consider that finding partners in this sector is normal (risk business). Accordingly, they consider this transaction **neutral form a tax viewpoint** (i.e. no gain for farmor**)** or **a step up**, is anyway granted.

Alternative Sources of Financing

SOURCE	DESCRIPTION
Royalty contract	▪ Royalties are non-participating interests sold to generate revenue for the operator. ▪ Usually, the holder receives a fixed rate (e.g. [X] USD per tonne) without deduction of costs from a specific property when production starts.
Streaming Contract (prepayment Contract)	▪ Investor makes upfront payment (deposit) in return for the right to purchase a fixed percentage of future production. ▪ On-going payments based on the deliver of production at a discounted price (hidden interest- normally credited against the deposit).
Exploration Finance Facility	▪ Developed only in Norway due to the exploration tax cost refund available in this country.
Supplier financing	▪ Essentially a field service supplier provides field services in exchange for a share of production. (Rare)

Financing Tax issues

- **Debt is cheaper than Equity** because lenders are willing to accept a lower return (for their lower risk) than investors and interest is tax deductible, whereas dividends to shareholders are not.

	Benefit of Leverage on Investor´s Return		
		Low Leverage	High Leverage
	Project cost	**1000**	**1000**
(a)	Debt	300	800
(b)	Equity	700	200
(c)	**Revenue from Project**	**100**	**100**
(d)	Interest rate on debt	5%	7%
(e)	**Interest payable**	**-15**	**-56**
(f)	**Profit**	**85**	**44**
	Return on Equity	**12%**	**22%**

- In the example above, if the tax rate is 30%, the **after-tax profit** in the low leverage case is 60 (85*70%), whereas in the high-leverage case is 31 (44*70%).

Financing Tax issues

- **Limitation of deductible interest based on fixed ratio tests**
  - **Ratio tests based o entity´s interest/earnings ratio (EBITDA)**
    - BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS
  - **Ratio test based on thin capitalization rules**
  - **Interest rate caps**

Guarantees

Guarantee Charges			
	Concept	**Bank**	**Intra-group**
Financial fee	Financial cost derived from the bank´s legal requirement to held a reserve for the issuance of guarantees.	✓ Financial guarantors disclose the scope and intend of their guarantees in financial statements notes.	✗ Guarantees issued between parent companies and subsidiary do not have to be recorded as liabilities on balance sheet.
Risk´s fee	Depending on the risk profile of debtor.	✓	≠ (1)
Commercial Margin	Commercial margin.	✓ Fee charged depending on the commercial interest of the bank with respect to the client.	≠ (1)
Management fee	A fee is charged because of administration costs.	✓	✓

(1) Many factors needs to be taken into account, specially the benefit that the subsidiary would obtain. OECD recognized that TP methods cannot reliably be used due to (i) **lack of internal comparables** (price between an associated company and an unrelated third party), since they depend on specific circumstances of the relationship between the unrelated contractor and the unrelated client, and (ii) the fact that external comparables (price between two unrelated parties) are not common and, in any case, would require a **thorough comparability analysis** which, in the absence of appropriate data, would lead to unreliable information unable to be used to determine the guarantee fees based on the arm´s length principle.

Parent Guarantees

- **MNE groups** have the advantage of accessing to other group companies resources (e.g.: funding). In particular, less capable entities can improve their creditworthiness if a related company provides them with a guarantee. In this respect, within a group, guarantees are provided to unrelated third parties to secure the obligations of other group companies (pledges to fulfill their obligations in case they fail to do so themselves).
- **Types of parent guarantees**
  - **Financial Guarantees:** a promise to take responsibility for another company's **financial obligation (principal sum plus interest thereon)** if that company cannot meet its obligation.
  - **Non-financial Guarantees (performance guarantee):** also known as a contract bond, provide security for non-financial obligations issued to one party as a guarantee against the failure of the other party to meet obligations in the contract (other than obligations in respect of payments, indebtedness or other monetary obligations of any kind) as agreed between the parties. In particular, in respect of the **delivery of goods or the completion of a project or of guaranteeing the quality of an outcome**. Performance guarantees are normally used in sectors where long-term and large contracts prevail, such as the **natural resources** or construction. As such, it involves **three parties**:
    - ✓ **the client –** an unrelated entity seeking to buy goods or services from the group;
    - ✓ **the contractor –** a group company that is primarily responsible for completing obligations towards the client; and
    - ✓ **the guarantor –** a group company that promises to step in and take over if the contractor cannot fulfill its obligations.

Parent Guarantees

- The **OECD 2017 TP Guidelines** consider that intra-group performance guarantees should be paid for when:
  - The guarantor performs a **deliberate concerted action** (mere passive association is not enough), and
  - The **contractor benefits from this action** (enhance its commercial or financial position).
- **Deliberate concerted action**: Issuing a formal intra-group performance guarantee meets this condition. However, it is common that less formal documents aimed at supporting affiliates exists (e.g., letters of comfort). Issuing a letter of comfort is a deliberate concerted action, however according to the OECD discussion draft on financial transactions, letters of comfort fall under a passive association as they simply confirm certain facts.
- **Benefits from this action:** In general, intra-group performance guarantees aim to enable the affiliate to compete for a contract. However, circumstances of every performance guarantee differ, which may lead to not charging a fee:
  - In many cases, intra-group performance guarantees are a mere **formal requirement**. The guaranteed entity is perceived as having better creditworthiness only because of its group affiliation (so-called "implicit support") and plays a very limited role or is legally required to obtain a guarantee by domestic regulations.
  - The benefit is for the whole group, not of the subsidiary who has no debt capacity or credit status and, therefore, would **not be able to access the capital market** without the financial guarantee. In essence, a third party would never provide a loan to this debtor absent an intercompany guarantee (would be commercial y unrealistic). E.g.: E&P projects
  - In addition, intra-group performance guarantees can be regarded as an equivalent of **a promise to increase the affiliate's capital** if needed (i.e.: a shareholder activity) and thus should not be remunerated.

Parent Guarantees

- **Issuance of bonds**
  - O&G companies may issue bonds or securities in the market to fund their projects through intra-group loans. A parent company guarantee is provided in favour of the affiliate (sometimes in a third country) that operates as the issuer of record. The parent guarantee will not be required to be compensated for the following reasons:
    - Normally, the associated company (debtor) has **no debt capacity or credit status** and, therefore, a third party would never provide a loan to this debtor absent an intercompany guarantee.
    - In this respect, a guarantee by the parent company may be considered a **shareholder service** as the circumstances of the guarantee were not that of a guarantor (i.e. to earn a guarantee fee).
    - It is the group, as a **single unity**, who requests funds from the market. The bond/security holders analyze risks and take their investment decisions based on the creditworthiness of the group as a whole.
    - The guaranteed entity is perceived as having better creditworthiness only because of its group affiliation (**"implicit support"**) .
    - The associated company that operates as issuer or record **plays a very limited role** (mere instrumental intermediator) and the function of the guarantee is merely of an instrumental nature.

Hedging

- **Risk management, financial risks & hedging policy.**
  - O&G companies are subject to a number of risks derived from the fluctuation of prices of commodities, currencies, interest rates, securities.. that are **out of the control of the entity** since they are driven by external market forces.
  - Without hedging the company would get exposed to such risks. Hedging is a **preventive risk management** dealing with mitigating or transfer the risk of uncertainty related to adverse fluctuations in order to limit or offset probability of loss.

Hedging = Reducing uncertainty in the market.

- **Hedging of commodity price risk.**
  - Risk mitigation of exposure to fluctuations in operating costs attributable to changes in commodity reference prices (e.g. prices of petroleum products).
  - The advantage is that provides the ability to minimize cash flow fluctuations attributed by commodity price movements.
- **Hedging of financial risks.**
  - Risk mitigation of interest and currency fluctuations.

Hedging

- **Tax treatment .**
  - In general, gains or losses derived from hedging transactions are treated as ordinary business income or other income.
  - **Attribution to PE**: if the respective hedging is entered to hedge specific risks of a people function, of an asset or a transaction if such people function, asset or transaction is allocated to that permanent establishment.
  - **After tax hedging**: taking opposite positions in respect of an amount so, on an after-tax basis the risk associated with one position is neutralized by the results from the opposite position (profit/loss). If tax treatment of the results were not symmetrical (gains not taxable/losses deductible).
  - Certain countries provides for **loss limitation rules** aimed at restricting the use of hedging artificially and solely intended for loss recognition. However, sometimes may be difficult to distinguish legitimate hedging designed to manage volatility risks with abuse schemes. Other anti-abuse regulations:
    - GAAR and SAAR regulations: to disregard losses from abusive hedging. They can be considered a preventive instrument, but might create uncertainty and burdensome administrative issues without substantial impact.
    - Separate tax treatment: losses can only be set against gains on similar instruments, but seems too strict setting apart legitimate losses and could lead to double taxation.
    - Establish margin ratio systems: for example, losses from certain instruments can not exceed a determined market price, however might not be consistent with the arm´s length principle.
    - Enhanced exchange of information (Action 5 of BEPS).

Annex 5: Financial Transactions in the Extractive Industries

1. Introduction

A. Capital Investment needs & decisions

- Investments Risks
- Change of law risks
- Quasi-political risks

B. Investment Returns

2. Traditional Sources of Financing

A. Capital

B. Debt

3. Financing in the Extractive Industry

A. Supply Change Financing

- Upstream
- Downstream

B. Farm-in/Farm-outs

C. Alternative Sources of Financing in the IE

- Royalty contract
- Streaming Contract (prepayment Contract)
- Exploration Finance Facility
- Supplier financing

4. Financing Tax issues

A. Limitation of deductible interest

B. Guarantees

- Guarantees charges
- Financial guarantees
- Non-financial guarantees

C. Hedging

Annex 6: General outline for a Chapter on TAX INCENTIVES in the Handbook

Chapter Overview:

Many developing countries use "tax incentives" in the hope of attracting additional domestic and foreign investment. Their effectiveness is often disputed, not least in relation to the extractive sector, which involves location specific resources. Nonetheless, governments may determine they would still benefit from offering incentives to extractive companies.

This Chapter provides a framework for assessing appropriate design and use of tax incentives, bearing in mind the various trade-offs, and interaction with the broader fiscal regime. It also proposes measures to manage the administration, and governance of tax incentives.

1. Introduction

a. Identifying tax incentives

- In general, the fiscal regime (and hence the fiscal take) relating to extractives deviates from the basic tax treatment for corporates in a country. The fiscal regime generally reflects the risks and rewards to be had from the development of the natural resources at hand, as well as the allocation between resource state and investor. Therefore, what is appropriate in one country or regarding one type of resource may not be appropriate for others.

- To start an effective assessment, the chapter will briefly outline the basic fiscal regimes that could apply to extractive industries and show that these are the benchmarks countries tend to choose. These basic fiscal regimes are drawn from the chapter on the government fiscal take in the earlier version of the Handbook:

    - Profit-based taxation:
        - Corporate profits tax; resource rent tax; windfall profits tax; tax on mining revenue; an additional tax on cash flow
        - Special features include: depreciation for capital expenditure deduction (often accelerated); depreciation uplift related to investment costs; ring-fencing
    - Production-related taxation:
        - Royalties
        - Production-sharing
    - Indirect taxation:
        - Value-Added-Tax
        - Import/ export related taxes, duties, fees;
        - Excise taxes

- Once a country has selected a "type" of fiscal regime it is possible to identify measures that are more generous than the regime and hence constitute a "tax incentive."

- For the purpose of this chapter, and considering the variety of extractive industry fiscal regimes, it is not possible to identify all possible deviations. What may appear in isolation as an incentive, may in fact be the natural corollary of a restriction elsewhere in the regime (for example, the immediate expensing of capital expenditure may appear to be an incentive, when in fact it is the natural outcome of adopting a cash flow tax approach and denying relief for borrowing costs). Instead, the chapter will discuss the pros and cons of typical incentives commonly used in extractives that are defined with respect to the main fiscal regimes previously outlined.

b. Tax incentives: the legal framework

- It is common for countries to have numerous sources of law governing extractive industry revenue collection. In addition to the income tax code, which may include a schedule on extractive industry taxation, there may be fiscal provisions in the mining and oil and gas laws, as well as in investment agreements, investment promotions laws, and double tax treaties. Each source of law may contain tax incentives. In this section we will outline the various sources of law that may contain tax incentives, and the interaction between them.

2. Design and Use of Tax Incentives

a. Driving principles

- Clear policy objective - Often incentives are given without clear objectives in mind, or an understanding of the possible alternative ways, other than through tax, to achieve the same aim. Where governments do decide to use tax incentives, they should be linked to specific policy objectives (e.g. attracting investment, local content, sustainability). We will also consider how the role of incentives may differ depending on the stage of the project.
- Predictability – both on government revenues as on investors return. Considering aspects such as time limitation on incentives, use of built in slides scales etc.
- Legality/legal certainty – to prefer introduction through appropriate legal instruments.
- Simplicity – improving predictability and effective use of resources.

b. Typical tax incentives

- This section will provide a detailed discussion of the types of tax incentives that are particularly common in the extractives sector. These include:

    - Income tax holidays
    - Investment allowances and credits
    - Withholding taxes on income remitted abroad
    - Custom duty reductions or exemptions
    - Export processing zones
    - Fiscal stabilisation

- For each incentive, we will discuss the pro's and con's, how it works in practice, including: government objectives, design and administration issues, interaction with other incentives, as well as possible costs and benefits, and risks of abuse. Practical examples and real case studies will be used wherever possible. We will also consider more general design issues such as time and scope of incentives, parameters for review, sunset clauses, and parallel fiscal regimes.

- One of the aims of the chapter is to differentiate between tax incentives, in particular why some incentives may have a stronger economic rationale and others less so (for example, custom duty reductions compared to income tax holidays). The result will be a high-level ranking of incentives, based on their effectiveness, according to the drivers of investment decisions in the extractive sector, and relevant empirical evidence.

c. Measuring the efficiency of tax incentives

- The lower the cost of the incentive in meeting the policy objective, the more efficient it is. In this section we will discuss the relevant indicators that can help determine the efficiency of an incentive, where possible illustrated by [successful or unsuccessful] examples. This would include:

    - *The redundancy rate:* Whether the objective has been achieved i.e. would the investment would have happened without the incentive? Whether the investment pipeline is balanced? In determining the redundancy rate careful consideration must be given to the level of tax competition. A government might rationally offer incentives that go beyond simply providing an investor with a threshold level of profit, if other countries are offering richer incentives.
    - *The cost of administering the incentive:* Incentives increase the complexity of the fiscal regime, and hence the human and financial

resources required to administer it. Some incentives are easier to administer than others, e.g. building on information already available.
    - *Government revenue losses:* Incentives may result in unintended revenue losses for government. This section will highlight the potential for inefficiencies arising from investors changing their behaviour in response to an incentive to maximise the tax benefit in ways that were not envisaged by government.
    - *Alignment with other government policies:* even if the objective of a specific incentive is clear, if not in line with or in absence of aligned government policy, this may not be helpful.

- We will also highlight the various tools available to governments to determine whether incentives are necessary (i.e. financial modelling); and efficient and effective (i.e. cost benefit analysis, and tax expenditure analysis). We will stress that financial modelling take into account the full extent of the benefits from mining, oil and gas investments, including economic growth, employment, and government revenue.

d. International legal and regulatory framework restrictions

- Countries using poorly designed incentives risk contravening the OECD initiative on Harmful Tax Competition, and, more recently BEPS Action 5, as well as the European Union non-cooperative jurisdiction list. Where a preferential regime is found to be harmful, the relevant country will be required to abolish it or remove the features creating the harmful effect.
- In this section we will briefly highlight the features of a "harmful preferential regime" and give examples of tax incentives that may be characterised as such (e.g. tax holidays, special economic zones).
- Interaction with investment protection treaties
- Consideration for State Aid like limitations

3. Administration of Tax Incentives

a. Responsibility for granting tax incentives

- Numerous government agencies may have the right to grant tax incentives (e.g. investment promotion agencies, ministries of finance, natural resource departments, national oil companies, and the executive etc). This may lead to duplication of incentives; uncertainty for investors; increased complexity in terms of administration and monitoring. There is also a potential for conflict of interest in cases where agencies also have performance targets (e.g. attracting investment.)

- In this section we will propose strategies for better coordination amongst governments with respect to the design, use, and administration of tax incentives in the extractive sector. Linking back to the earlier section on policy objectives, and the need for a common vision for the sector.

4. Governance of Tax Incentives

a. Transparency

- Transparency is necessary to ensure efficient and effective use of tax incentives, and to avoid the possibility of political corruption emerging in the process of granting incentives. This section will explore the options for improving transparency of incentives –
    - Contract disclosure (linking to new requirement under the EITI standard).
    - Clear measurable policy objectives
    - Incentives prescribed in the law, including criteria for granting incentives

b. Monitoring of incentives

- Triage instrument – our intention is to support tax authorities in choosing what deviations they will focus on to ensure that they are and remain effective. In providing guidance on what incentives are likely to be unproblematic and which can be more problematic, tax authorities can maximise the impact of their resources and provide certainty at the same time. We will propose a risk-based approach to monitoring based on principles and effectiveness assessment.
- Regular calculation and reporting of revenue gains and losses attributable to incentives, based on prioritising as described above.
- Opportunities for review (sunset clauses) – link to chapter on negotiation and renegotiation of contracts

5. Conclusion

Annex 7

Distr.: General
1 October 2018

Original: English

Committee of Experts on International Cooperation in Tax Matters
Seventeenth session
Geneva, 16–19 October 2018
Item 3(c)(ii) of the provisional agenda
Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries

Note by the Secretariat

During the fifteenth session of the Committee of Experts on International Cooperation in Tax Matters (Committee), the coordinator of the Subcommittee on Extractive Industries Taxation Issues (Subcommittee), Mr. Eric Mensah, made a recommendation, endorsed by the Committee, to review and expand the Handbook on Extractive Industries Taxation Issues by Developing Countries (Handbook).

The review of the Handbook would be conducted to revise the relevance, for developing countries, of the guidance of topics included therein; the expansion would cover additional areas of priority for developing countries, including: practical guidance on auditing mining and oil and gas activities; trade mispricing issues (to the extent that these are not transfer pricing issue); the tax treatment of service providers and subcontractors; the tax treatment of financial transactions related to the extractive industries; environmental tax issues, and tax incentives.

Within this framework, the Subcommittee met in Madrid, Spain, on 20-21 June 2018, with the aim of discussing the expansion of the Handbook; the update of existing chapters would be conducted as a second step, to ensure consistency between the expansion and the update.

During the meeting, members of the Subcommittee provided presentations on topics to be included in the expansion of the Handbook, and discussed whether such topics should be incorporated into existing chapters, or whether new chapters should be created. The Subcommittee reached consensus on the development of seven new chapters, following the guidelines of the Committee, on the following topics: 1) auditing of oil, gas and mining activities; 2) tax treatment of subcontractors and service providers; 3) production sharing contracts; 4); environmental tax issues; 5) tax incentives in the extractive industry; 6) tax treatment of financial transactions (including a sub-chapter on farm in/out); and 7) trade misinvoicing.

During the meeting, working groups were created (each composed by 5-7 Subcommittee members, with a group lead), and produced outlines for each chapter of the expansion of the

Handbook. Such outlines were then shared with the whole Subcommittee, and their comments were incorporated.

The proposed outlines of new chapters can be found in the annex, for discussion and endorsement by the Committee at its seventeenth session.

The Subcommittee aims to meet again in the first quarter of 2019, with the aim to advance work on the new chapter outlines, and to start discussions on the update of existing chapters of the Handbook.

Outline of chapters for the expansion of the Handbook on Extractive Industries Taxation Issues by Developing Countries (Handbook)

The proposed new chapter numbering, following the expansion of the Handbook, would be as follows:

Old chapter number	New chapter number	Chapter title
1	1	Overview
2	2	Tax treaty issues
3	3	Permanent establishment issues
	4	[New] Tax treatment of subcontractors and service providers
4	5	Indirect transfer of assets
5	6	Transfer pricing issues
	7	[New] Trade misinvoicing issues
6	8	The tax treatment of decommissioning
7	9	The government's fiscal take
	10	[New] Production Sharing Contracts
8	11	Tax aspects of negotiation and renegotiation of contracts
	12	[New] Tax incentives
	13	[New] Financing issues; including hedging, finance leasing, debt financing, thin capitalization [Including a sub-chapter on farm in/farm out]
9	14	Value added tax
	15	[New] Issues and best practices in auditing oil and gas or mining activities

Chapter 4: Tax Treatment of Subcontractors and Service Providers

Chapter 4.1: Overview

4.1.1 Description of chapter, from approach and analysis from domestic taxation standpoint. Intention is to not repeat content covered by Chapters 2, 3 and 5 (Treaty, PE and Transfer Pricing), but only to cover issues specific to the tax treatment of Service Providers and subcontractors. Broad definition of these terms, and their usage (e.g. Service Provider would include the major firms like Schlumberger, Halliburton, Bechtel, etc., while subcontractors would be firms that work for those companies. The coverage would be restricted to taxation issues, and local content, training, skill development of partner NOCs, etc. issues could be referred to here only to mention that they would not be covered in the chapter. Benefits for developing country tax administrations from clarity and certainty for business. The chapter will also use case studies to identify practical issues.

4.1.2 Contractor and subcontractor issues specific to affiliates should be dealt with at Chapter 6 (Transfer Pricing) with a reference here to 4.2.5.

4.1.3 Discussion is on the taxation of the profits of the service providers/subcontractors and the taxation of the salaries of their staff.

4.1.4 Standardized definitions

Chapter 4.2: Role of Service providers and subcontractors in the extractive sector

4.2.1 Value chain in the extractive sector and position of contractors/subcontractors

4.2.2 Location of services provided

4.2.3 Resident and non-resident contractors,

4.2.4 Wholly owned contractors and subcontractors of resource sector companies

4.2.5 Very short-term Contractors and Individual Contractors/technical engineers

Chapter 4.3: Inventory of Service providers' services by stage of extractive activity

4.3.1 Contract development stage E.g. Consulting and research, Advisory firms

4.3.2 Exploration stage E.g. Geological mapping and surveys, Seismic capture/sampling, Analysis, Test drilling/excavation

4.3.3 Development Production drilling/facilities, Platforms and mine construction,

4.3.4 Production and distribution e.g. Production support, Pipelines and transportation, Byproduct processing

4.3.5 Ancillary catering, tugging, anchor handling, firefighting; standby services

4.3.6 Decommissioning e.g. Removal of structures and Restoration of land surface

Chapter 4.4: Special challenges in service provider/subcontractor tax issues

4.4.1 Main tax issues for consideration (at headline level with rationale – e.g. withholding tax, characterization of income, PE issues, other treaty issues,

4.4.2 Outline of case studies used. (Process of developing case studies through engagement with government/ tax administrations and companies in services sector)

4.4.3 Broad technical issues (Would cover overarching areas such as need to address mismatches, describe challenges around split contracts with reference to the direct and indirect tax components to be discussed in detail under the headings below, upcoming challenges from new technological developments, increased use of intangibles)

4.4.4 Tax treatment of depreciation: Issues relating to valuation for tax purposes of movable assets that are transferred into and out of a taxing jurisdiction, e.g. for depreciation, balancing charges or capital gains on deemed realisation.

4.4.5 Tax issues arising from unused/stored equipment.

4.4.6 Treatment of services rendered by the Head Office of service providers and subcontractors.

Chapter 4.5: Characterization of income and withholding tax issues in domestic law and tax treaties

4.5.1 Charge to WHT for typical contractor/subcontractor income under domestic law and treaty practices (Interaction of WHT vs business income treatment, possible models for treatment)

4.5.2 Characterization of technical service fees and payments to non-resident service providers with reference to case studies used (Should cover impact of contractual terms, including "holds harmless" clauses, royalty treatment; x-ref to clarify that affiliate technical service fees are dealt with in Chapter 6 [transfer pricing issues] of Handbook.)

4.5.3 Tax treatment of leased assets and of lease payments

4.5.4 Computation issues (Gross up, possibilities of duplication of charge, analysis of service contracts)

4.5.5 Treaty issues in technical service fees (Impact of new Article 12A of the UNMC. Application of current treaties without Article 12A inspired language, reference to the limited number of treaties with explicit technical services articles, Treaties with old Art 12 language "for information concerning industrial, commercial or scientific

experience", Treaties completely silent on technical service fees, reference to UNMC Commentary with focus only on application to contractor/subcontractor services)

4.5.6 Use of ships. MODU (Mobile Offshore Drilling Units) and aircraft by service providers (Interaction with relevant articles in treaties, reference to UNMC Commentary and address drilling or seismic exploration vessels)

4.5.7 Related party issues and allocation of taxing rights (Art 12A (7))

4.5.8 Order of charge – deemed PE determination vs WHT application

4.5.9 Relief for WHT in residence State

4.5.10 Good practices in filing and administration, (Clarity on thresholds and documentation requirements, utilizing additional information sources to reduce compliance burdens, sharing of practices to reduce compliance challenges).

Chapter 4.6: PE issues in domestic law and treaties

4.6.1 Domestic law and treaty definitions (Difference in definitions and impact on contractors/subcontractors using case studies; good practices in providing clarity and certainty to taxpayers)

4.6.2 Scope of application and status of service providers (E.g. do domestic law or treaty provisions cover the territorial waters including EEZ of a jurisdiction or the continental shelf Status of service providers under older treaties before update to the UN model treaty)

4.6.3 PE identification and thresholds (Principles for PE identification for contractors/subcontractors. Possible discussion on inclusions in 5(2)(f) UNMC. E.g. present Commentary silent but discusses drilling vessel, which can often be owned by a service provider;)

4.6.4 Site PE Issues (Art 5(3)(a) UNMC) for service providers, Identification of service provider role in site, Contracts split over tax years, Contracts with break in services where unrelated sub of contractor has performed services, tests at para 11 of Commentary to UNMC in light of case studies)

4.6.5 Service PE issues (Art 5(3)(b) UNMC) and equivalent domestic law principles; Connected services; Examination of question of establishing PE through performance of services including consultancy services, - applicable tests, split services, purely remote services such as seismic analysis, management and operation services performed on service client site, connected services under treaties signed under old model.)

4.6.6 PE Issues around use of subcontractors by contractors (UNMC language around "by an "enterprise through employees or other personnel engaged by the enterprise for the

purpose in a jurisdiction" Some countries view crews on rigs as "mariners" while some do not.

4.6.7 PE issues around split contracts (attribution of service by non-residents to PEs of group companies, services split between related parties, connected services attributed to different companies, digitalization of services as enabler)

Chapter 4.7. Indirect taxation issues

4.7.1 Application of VAT/GST for contractors/subcontractors (Determination of the place of taxation for cross border supplies of services and intangibles, territorial scope for application of the VAT – e.g. continental shelf inclusion in VAT law, limited or absence of domestic place of supply rules for services)

4.7.2 Methods of VAT collection and reclaiming input tax (e.g. application of a reverse charge on remote supplies, services provided from mobile platforms like ships and aircraft, interjurisdictional issues, administrative procedures)

4.7.3 Use of special regimes (Supplies by a party with a temporary place of supply, Voluntary VAT registration in a jurisdiction/reclaiming inputs, use of credit mechanisms for resource companies to encourage registration, Inter State movement of capital equipment and its treatment for GST/VAT purposes specifically in EU and country like India.)

4.7.4 VAT issues for contractors in decommissioning/rectification (no client output VAT to be relieved, refunds mechanisms)

4.7.5 Customs duty and import VAT issues (temporary admission issues such as high value exploration equipment brought in temporarily, classification issues – (e.g. is a MODU a vessel or not), Application of charges and use of depreciated value for re-export, multiple users of same equipment, tracking of assets subject to incentives, valuation of assets, establishing benchmark values, ringfencing of assets, rules for second hand equipment, rules on related party asset transfers, project area limitations for incentives).

4.7.6 Good practices for VAT and Customs treatment in negotiating concession agreements

4.7.7 VAT issues for subcontractors of service providers – application of reverse charge mechanisms

4.7.8 Administration issues of refunds and registration (Application of domestic provisions on VAT registration and refunds, alternative and more efficient solutions, recognition that short-term nature of work by Service Providers may cause difficulties in jurisdictions where it takes a long time to register for VAT/GST)

4.7.9 Treatment of services procured by Head Office for VAT purposes. In short term contract market, it is industry practice to share the procurement of services between Head Office

and the local PE as well as for centralization of certain work at Head Office/Regional Office level.

Chapter 4.8: Anti-avoidance and revenue risk management

4.8.1 Risk assessment (Conclusions drawn from case studies, issues thrown up by greater use of intangibles, complications from fragmentation of physical operations and business functions in digital economy, reduced need for physical presence)

4.8.2 Transfer pricing challenges (limited text to only refer to guidance in chapter 5 and identify issues specific to contractors/subcontractors)

4.8.3 Solutions and risk minimization (Clarity on characterisation of transactions as technical services, and related guidance)

4.8.4 Strengthening of permanent establishment provisions: Strengthened PE concepts including the BEPS action 7 as now included in the UN Model, approaches to make these more effective.

Chapter 4.9: Issues around very small subcontractors or short-term subcontractors to Service Providers

4.9.1 Status and characterization of service providers for tax purposes (Industry characterized by layers of contractors, down to individual service companies, examples)

4.9.2 Tax issues related to individual service companies (Tax residence and PE status, treating individual subcontractor as an employee for income tax purposes, determining who is the relevant employer in situations of e.g. hiring out of labour (employees), including WHT and social security contributions, etc recharacterizing service providers from independent subcontractors to employees, Management/ personal service companies and anti-avoidance). Possible approaches to solution such as chain responsibility including for instance for wage tax, public and employee social security rules.

4.9.3 Tax treaty issues (Application of domestic law in identifying contracts of service, allocation of taxing rights under Art. 15(2)). Address issue of deemed PE on continental shelf which has effects under traditional art.15 application but also special rules not requiring 183-day presence for taxing the salaries. Application of 15(2)(c), remuneration borne by the deemed employer in the host country in absence of presence of legal employer)

4.9.4 Administrative and compliance issues (E.g. where subcontractors have left the jurisdiction when queries are raised, liability of contractors as deemed employers, guidelines and good practices)

Chapter 4.10: Miscellaneous tax issues

4.10.1 Treatment of service companies within incentive regimes for the extractives sector (major item in the mining industry)

4.10.2 Contractor treatment in Production Sharing Contracts (E.g. there may be provisions affecting subcontractor tax in PSCs and in some cases a rate of withholding tax on the subcontractor or specific treatment for VAT may be set out in the agreement.)

4.10.3 Role of NOCs in "tax paid" PSC structures - status of contractors.

4.10.4 Application of fiscal stability clauses to contractors

4.10.5 Other policy areas (Local content, skills dev and training, coordination between ministries)

4.10.6 Tax Treaty Models for good practices (Use of ATAF Models?)

4.10.7 Payroll Taxes:

4.10.8 Treatment of mobile employees and the payroll entity in the host country. Economic employer v. Legal employer (major item in the mining industry)

4.10.9 Applicability of Social Security Contribution E.g. for short term employees (with or without Totalization Agreements).

4.10.10 Registration for payroll Individual tax registrations v. Employer's registration for group filing, tax payments and even tax audits

4.10.11 Treaty benefits in deemed profit jurisdictions. Satisfaction of clause 15(2)(c) of UNMC

Chapter 6: Trade misinvoicing issues*

Chapter 6.1: Overview

6.1.1 Summary of issues discussed in the chapter

6.1.2 Brief overview of the difference between transfer mispricing vs. trade misinvoicing.

(a) Transfer mispricing consists of illegally inflating or deflating prices as a means of shifting profits across territories to take advantage of differences in taxation regimes and must be distinguished from the typical transfer pricing dispute between a taxpayer and a government where both parties have legitimate positions for the prices being presented. In this case, there are no discrepancies between recorded exports and recorded imports, since the same price is used and reported on both sides of the transaction.

* The mandate given by Committee included the inspection of trade mispricing issues, which is an umbrella term that includes both transfer mispricing and trade misinvoicing issues. Since Chapter 5 of the Handbook covers transfer mispricing issues, this chapter will specifically address trade misinvoicing issues.

(b) Therefore, transfer mispricing results in tax revenue losses, but the transferred profit itself does not constitute capital flight (because the outflow is recorded). However, it may constitute an illicit financial flow†.

(c) Additionally, in transfer mispricing the involved entities are related, while trade misinvoicing is usually performed through a (formally) unrelated entity or intermediary.

(d) For this reason, country-by-country reporting may not be of assistance in trade misinvoicing cases.

Chapter 6.2: Purpose

(a) The purpose of this topic is to provide an overview of transfer misinvoicing issues related to the extractive industries; to clarify the definition of terms used to address trade mispricing; and to identify and discuss administrative considerations and measures that countries have implemented or could consider implementing.

(b) The approach of the topic, rather than theoretical, will be mostly practical to assist developing countries to understand the terms and identify issues and its possible solutions, with a main focus on administrative considerations.

(c) Trade misinvoicing issues are broadly relevant for the extractive industries. According to some sources, trade misinvoicing is considered one of the main sources of capital flight, which is a major mechanism through which developing countries lose revenue. Also, commodities may be more prone to trade misinvoicing than other products (due to the complexity of the operations, the large volumes and the limited regulatory and administrative capacity of tax authorities from developing countries to monitor the transactions).

Chapter 6.3: Definitions. "Trade mispricing" is used as an umbrella term that encompasses both transfer mispricing and trade misinvoicing (or false invoicing).

(a) Trade misinvoicing refers to the illegal manipulation of a transaction (regarding quantity, quality, etc.), conducted between non-related parties, which may result in discrepancies in bilateral trade data (it should be noted, however, that there may be additional causes for such discrepancies, including inaccuracy in statistical reporting)

(b) In the existing literature regarding trade mispricing, there is no uniformity as to how the terms "trade mispricing" and "trade misinvoicing" should be used.

(c) According to the *Report of* the *High Level Panel on Illicit Financial Flows from Africa*, Trade misinvoicing is the act of misrepresenting the price or quantity of imports or exports in order to hide or accumulate money in other jurisdictions. The motive could, for example, be to evade taxes, avoid customs duties, transfer a kickback or launder

† Illicit financial flows are capital flows that are illegal in the way they are created, transferred, or utilized

money. Trade-based money laundering is a technique where trade mispricing is used to hide or disguise income generated from illegal activity. Trade mispricing is the falsification of the price, quality and quantity values of traded goods for a variety of purposes. These could range from the desire to evade customs duties and domestic levies to the intent to export foreign exchange abroad.

(d) According to *Global Financial Integrity:* Trade misinvoicing is the deliberate manipulation of the price, quality or quantity (value or volume) of an international commercial transaction of goods or services by at least one party to the transaction.

(e) According to UNCTAD: Trade misinvoicing consists of either "perverse" discrepancies or "excessive normal" discrepancies in partner trade statistics derived from the comparison of the value of exports as reported by the exporter to the value of imports as reported by the importer. The first case is when the comparison of partner data reveals discrepancies in the "wrong" direction, such as export overinvoicing or import underinvoiced; in the second case, the flow is in the right direction, but there are "excessive normal" discrepancies that exceeds reasonable values; this latter case constitutes capital flight and happens through export underinvoicing or import overinvoicing.

Chapter 6.4: Trade misinvoicing issues that may arise in the extractive industries

6.4.1 Underinvoicing of imports, not purely related to custom duties. Important to be aware of commentators that argue that the discrepancies in trade data come from statistics shortcomings rather than always manipulations (underinvoicing or overinvoicing); this is relevant to consider when investigating the issue

6.4.2 Misinvoicing of services and intangibles such as intra-group loans and intellectual property and management fees may account for an increasing contribution to illicit financial flows, due to change in technology, lack of comparative price information, and share of service in global trade

6.4.3 Quantification (quality, quantity, price and other aspects) of actual traded commodities: (a) Tax authorities may lack information on how to evaluate and price commodities in the extractive industries; (b) Also, some developing countries lack the means to verify the quantities of natural resources produced, relying instead on exporter declarations; (c) Some products in the extractive industries, such as precious metals, have a high value and low weight, increasing the risk for smuggling and making it harder to control the transactions; (d) This guidance would be of benefit in both transfer pricing and non-transfer pricing cases.

6.4.4 Another relevant issue is that there might not be a system of standardized international pricing for some natural resources and the access to comparables could be difficult. This

may impact transfer pricing assessment, but it can also make it difficult to detect fraud. For instance, particular product shipments can be 'unique' and hence, tax authorities may be unable to compare it with other transactions;

6.4.5 In addition, there is a high discretionary control by governments over natural resources, resulting in considerable economic and political power to the administration, as well as the presence of tax incentives and export duties and tariffs.

6.4.6 Also, large companies in the extractive industries have substantial financial and market power and may be in a position to put pressure on host governments in order to influence the manner in which government's exercise control over the industry and the scope of regulations. The issue can be even more serious for developing countries, as these are often commodity-dependent, and their governments frequently have to deal with: (i) Difficulties to detect, track and monitor the operations; (ii) Poor enforcement of regulations (authorities may not have a sufficient number of qualified staff to apply tax rules); (iii) Lack of funds and limited resources; (iv) Low administrative transparency. These illicit actions may be hard to identify, as companies may engage in both legal and illegal trade simultaneously, making it difficult for authorities to detect misinvoicing, especially considering that the operations in the extractive industries usually involve large volumes and become quite complex. The extractive industries operations may be complex and tax authorities may not know what kind of information they need to look for or information may be difficult or expensive to obtain (such as in the case of informal practices or when the records are offshore).

Chapter 6.5: Administrative considerations

6.5.1 Enabling factors and costs of trade mispricing

(a) Most of the ways to address the trade misinvoicing issues are by administrative considerations.

(b) The motives behind trade misinvoicing are to maximize profits by avoiding tariffs or taking advantages of export subsidies; to take advantage of export subsidies or tax incentives; to circumvent exchange and customs control; or minimize administrative burdens, such as lengthy paperwork, delays in administrative authorizations and controls, in order to speed up execution.

(c) Trade misinvoicing may generate substantial costs for governments, both in the form of direct costs (affecting foreign exchange, lost government revenues from tax/levies, or tax credits issued on inflated value of exports), as well as indirect costs (including the unfair distribution of gains from trade, and illicit financial flows result in lower potential for domestic resource mobilization).

(d) However, due to countries' difficulties in monitoring trade operations and generating reliable statistics, the magnitude of trade misinvoicing is difficult to estimate and may be very misleading. Focusing on this will be beneficial, looking to find ways that can lead to better risk assessment, while avoiding pitfalls of exaggerated claims of lost revenues, or missing areas where risks may be higher.‡

6.5.2 Detecting misinvoicing and recommendations. These difficulties can be addressed by:

(a) Implementing an efficient digital system in which information from tax authorities and customs can be cross checked;

(b) Promoting exchange of information among countries, especially between the key trade partners. There are two internationally recognised standards on transparency and exchange of information for tax purposes: exchange of information on request (EOIR) and automatic exchange of financial account information (AEOI). EOIR is built on three key components: availability of information; access to information and powers to obtain it; exchange of information agreements to provide the legal basis for exchange. For the AEOI, there are four core requirements: (i) translating the reporting and due diligence rules into domestic law; (ii) ensuring a legal basis is in place to automatically exchange information; (iii) putting in place information technology and administrative infrastructure; and (iv) protecting confidentiality and safeguarding data.

(c) In order to deal with difficulties regarding quantification (quality, quantity, price and other aspects) of traded commodities, it is important for tax authorities to build a deep understanding of the industry sector to avoid base erosion risks.

(d) Therefore, tax authorities should be aware of transfer pricing rules and documentation necessary, have an industry knowledge (such as understanding the value chain of the industry, commodity market functioning, common price adjustments, etc) and information networks (such as sharing knowledge with other agencies, both inside the country and at an international level).

(e) These considerations will also be useful to detect misinvoicing.

(f) To avoid duplication of work, important to refer to literature in references, in particular the toolkit and supplementary report of The Platform for Collaboration on Tax.

Chapter 6.6: Case examples [further discussion in the Subcommittee needed].

Inclusion of case studies of countries that successfully came up with solutions to deal with the issues arising from trade misinvoicing, or provide an explanation of the apparent discrepancies in trade data that imply misinvoicing.

‡ See, e.g., Maya Forstater, "making sense of international tax "big numbers": Billions and Trillions" and Alexandra and Maya Forstater, Inflated Expectations about Mineral Export Misinvoicing are Having Real Consequences in Tanzania, 2017

Chapter 10: Production Sharing Contracts

Chapter 10.1 Executive summary

Production Sharing contracts/arrangements (PSC or PSA) are the more common structures used in the petroleum industry, particularly in developing countries. The aim of this chapter is to analyse more in detail than in chapter 9 (new outline) the main tax and tax-related issues arising from this kind of contract. Nevertheless, at the beginning of the chapter we will provide information showing countries with PSCs versus other types of fiscal content; the reasons why a country choose the PSCs fiscal regime and general description of typical PSCs, types of terms and other general topics can be found.

Important aspects of the PSC regime that impact considerably in the tax field are also treated: The role of the Tax Administration in the negotiation of PSCs and the interaction of the different figures of the Government take.

This chapter will help to better understand the tax mechanisms of the contracts and will be useful for tax administration, investors and other stakeholders.

Note: In some areas, some particular points are rather narrow. However, we think that it is better to keep in for the initial outline to be rather comprehensive, but as we go forward in the actual drafting, we might consider combining some items or eliminating them as less central to the objective of the chapter.

Chapter 10.2 Introduction

Why a country may want to utilize PSCs as its fiscal term structure and where PSCs are found today.

Chapter 10.3 What is a PSC?

A general description of typical PSC's, most common terms, with some specific examples showing variations.

Chapter 10.4 Negotiating a PSC

Tax Administration shall be involved in the negotiation. (For example: avoidance of tax conflicts).

10.4.1 General tax regime principles for the PSC: clear definition of applicable taxes and exemptions.

10.4.2 Procedure for resolution of tax conflicts when drafting PSC agreements.

10.4.3 Tax planning schemes.

10.4.4 Profit Sharing ratio.

10.4.5 Applicable Royalty rates

10.4.6 Powers of the Minister to set royalty rates.

Chapter 10.5 Government Take Overview (See Chapter …)

Overview of non-tax government take, tax government take, and issues of interaction (including the interaction with the domestic tax law and the tax treaties).

Chapter 10.6 Tax Issues in PSC regimes—Tax

10.6.1 Typical tax clauses in PSCs (with examples)

10.6.2 Clauses of determination and filing of Corporate Income Tax

10.6.2.1 Government determination

10.6.2.2 Contractor determination

10.6.2.3 Joint filing

10.6.2.4 Distinct filing

10.6.2.5 Issues/Challenges associated with both methods

10.6.3 Clauses of payment of Corporate Income Tax:

10.6.3.1 Direct payment by the contractor

10.6.3.2 Government (including National Companies) payment on behalf of the contractor.

10.6.3.3 Issuance of receipts

10.6.3.3.1 Will the receipt be issued in the name of the contractor or government?

10.6.3.3.2 Will the receipt be split between both parties?

10.6.3.4 Penalties for late payment.

10.6.3.5. Will payment be made in currency of transaction or domestic currency

10.6.4 Tax Stability clauses.

10.6.4.1 The principal Act.

10.6.4.2 Where the fiscal regime conflicts with another fiscal regime, which act takes superiority?

10.6.4.3 Assessment, objection and Adjudication procedures.

10.6.4.4 How to solve the differences.

10.6.5 Other taxes or charges included in the PSCs: are they deductibles in the CIT? (Branch Profit Tax, Windfall Profit taxes, Royalties, Bonuses, WHT Dividends …)

10.6.6 Tax Base determination:

10.6.6.1 General principle: maintaining it as simple as possible.

10.6.6.2 Ring Fence

10.6.6.3 The Uniformity Principle.

10.6.6.4 Depreciation rules.

10.6.6.5 Tax regime of decommissioning (see Chapter …)

10.6.6.6 Negative Offset Losses regime.

10.6.6.7 Evidencing claims for double taxation relief.

Chapter 10.7 Tax related issues stemming from non-tax clauses.

10.7.1 Contract period.

10.7.2 Ownership of assets.

10.7.3 Determination of profit oil and cost oil.

10.7.4 Recoverable costs: when are they deductible?

10.7.5 Obligations of the operator and the non-operators (including the overhead charges)

10.7.6 Transfer of assets / indirect transfers (see chapter…)

10.7.7 Divestment of interest in contract area.

10.7.8 Treatment of rejected costs by owner/holder of the license (non-recoverable costs)

Chapter 10.8 Typical PSCs tax conflicts issues: how to avoid them and solve them (see …)

10.8.1 Risk Assessment and Transfer Pricing

10.8.2 Benefits of joint ventures

10.8.3 MAP possibilities.

10.8.4 Investments Treaties.

Chapter 10.9 Country examples: Brazil, Nigeria, Indonesia, Vietnam?

Bibliography

Chapter 12: Tax incentives

Many developing countries use tax incentives in the hope of attracting domestic and foreign investment. Their effectiveness is often disputed, not least in relation to the extractive sector, which involves location specific resources. Nonetheless, governments may determine they would still benefit from offering incentives to extractive companies. This Chapter provides a framework for assessing appropriate design and use of tax incentives, bearing in mind the various trade-offs, and interaction with the broader fiscal regime. It also proposes measures to improve the administration, and governance of tax incentives.

Chapter 12.1 Introduction

12.1.1 Definition of a tax incentive

The analysis of tax incentives faces fundamental definitional challenges, related to the determination of the relevant benchmark. The benchmark, and hence what constitutes a tax incentive, will differ from country-to-country. This section will set out the definition of a tax incentive, taking into account the meaning used by the Platform for Collaboration on Tax (PCT) in its publication 'Options for Low-Income Countries Effective and Efficient Use of Tax Incentives.'

This section will link to the chapter on fiscal take, emphasising that incentives must be viewed in the context of the fiscal regime as a whole, and cannot, therefore, be evaluated in isolation.

12.1.2 Typical types of tax incentives

As stated above, what constitutes an incentive will vary from country-to-country depending on the benchmark fiscal regime, hence, it is not possible to provide a definitive list. Notwithstanding, to make the issues more real, this section will set out typical types of tax incentives governments may offer to mining, oil and gas investors.

12.1.3 Sources of law

Tax incentives may be contained in various sources of law. Again, linking to the chapter on fiscal take, this section will highlight the different layers of tax law that may contain incentives (e.g. income tax code, investment promotions law, tax treaties, sector-specific legislation, and contracts).

Chapter 12.2 Governance of Tax Incentives

12.2.1 Responsibility for granting tax incentives

(a) Numerous government agencies may have the right to grant tax incentives (e.g. investment promotion agencies, ministries of finance, natural resource departments,

national oil companies, and the executive etc). This may lead to duplication of incentives; uncertainty for investors; increased complexity in terms of administration and monitoring.

(b) There is a potential for conflict of interest in cases where agencies also have performance targets (e.g. attracting investment.)

12.2.2 Joined-up government

(a) Strategies for better coordination amongst governments with respect to the design, use, and administration of tax incentives in the extractive sector. Linking back to the earlier section on policy objectives, and the need for a common vision for the sector.

(b) Increased complexity in terms of administering and monitoring relevant policy objectives.

Chapter 12.3 Principles for the Design and Use of Specific Tax Incentives

12.3.1 Effectiveness

(a) Briefly define effectiveness (i.e. the incentive should achieve the relevant policy objective)

(b) Often incentives are given without clear objectives in mind, or an understanding of the possible alternative ways, other than through tax, to achieve the same aim. This section will encourage governments to (a) find solutions to their policy objectives that do not require tax incentives, (b) consider whether incentives are the most effective way to induce investment in the extractive sector (drawing on empirical evidence), and (c) link incentives to specific policy objectives (e.g. attracting investment, funding the government's equity interest in the project, local content, sustainability, etc. –connecting to other relevant sections of the Handbook).

(c) Consider the value chains for mining, and oil and gas – the different objectives, activities, and risks, and the potential implications for tax incentives.

12.3.2 Efficiency

(a) Briefly define efficiency (i.e. the cost of an incentive should not exceed the benefit). The sub-points are not exhaustive but a sample of some of the issues to be discussed here.

(i) Administration: Incentives increase the complexity of the fiscal regime, and hence the human and financial resources required to administer it.

(ii) Abuse: Incentives may result in unintended revenue losses for government. This section will highlight the potential for inefficiencies arising from investors changing their behaviour in response to an incentive to maximise the tax benefit in ways that were not envisaged by government.

(iii) Subcontractors: Subcontractors are often entitled to the same tax incentives as the companies responsible for extraction. This section will explore the application of incentives to subcontractors – whether this is necessary and/or appropriate; under what circumstances; and within what limits.

(b) Opportunities for review (sunset clauses).

12.3.3 Case studies

The principles outlined above will be used as a framework for evaluating some typical incentives. The aim is to illustrate what works and doesn't work, as well as the various trade-offs policy-makers need to consider. Potential incentives for evaluation include accelerated depreciation; tax holidays; import duties; withholding taxes; and deductions for contributions to environmental funds.

12.3.4 Tools

This section will highlight the various tools available to governments to determine whether incentives are necessary (i.e. financial modelling); efficient and effective (i.e. cost benefit analysis, and tax expenditure analysis).

Chapter 12.4 Administration of Tax Incentives

(a) Transparency is necessary to ensure efficient and effective use of tax incentives, and to avoid the possibility of political corruption emerging in the process of granting incentives. This section will explore the options for improving transparency of incentives

(i) Contract disclosure

(ii) Clear measurable policy objectives

(b) Monitoring of incentives

(i) Regular calculation, and reporting of revenue gains and losses attributable to incentives

(ii) Auditing of incentives, not from an efficiency or effectiveness perspective but simply whether the incentives are properly applied.

Chapter 12.6 Conclusion (TBD)

Chapter 13: The Tax Treatment of Financial Transactions

Chapter 13.1 Summary

Description of the Chapter aimed to summarize particularities of financing and financial transactions generally occurring in the extractive industries and the tax issues involved. Focus

on the most relevant or specific issues to the Upstream sector, including debt financing, hedging, finance leasing and thin capitalization [other financial transactions to be considered of interest to be included while Chapter is developed].

The rules governing the tax treatment of financial transactions are quite complex and technical.

In general, intra-group financial issues would not be within the scope of this Chapter so transfer pricing issues would not be primarily covered. However, financial transactions raise transfer pricing issues that are specific to EI and we need to see how these should be reflected in the chapter without duplicating the work of TP WG. This aspect could be referred for further coverage in Section 5 which could then be expanded to include TP issues specific to EI.

Accordingly, when required we recommend offering a brief explanation of the intra-group financial transactions with cross-reference to new Chapter 6 of the Handbook and the work of the Subcommittee on Transfer Pricing (proposed "Financial Transactions Chapter") for further information.

Chapter 13.2 Purpose

The aim of the Chapter is to offer guidance to policymakers and administrators in developing countries on particularities and sources of financial issues in the Extractive Industry, and recommendations issued by International organizations to tackle potential tax avoidance derived from abusive behavior.

This Chapter would attempt to assist policymakers and administrators in developing countries in evaluating the different tax options available to them when dealing with financial issues in the extractive industry, taking into consideration overall implications of their decisions in order to achieve a balance between the need of inward investment and the prevention of base erosion and profit shifting. Therefore, finding a balance to ensure that application of tax mechanisms does not adversely affect investment

Chapter 13.3 Terms used

[To be developed while drafting the chapter, but would include terms such EBITDA, "leverage buyouts", "free cash flow", "borrowing costs", etc.].

Chapter 13.4 Financing in the Extractive Industry

This part would briefly provide an overview of financing decisions and the different sources of financing in view of the capital-intensive nature and the varying degree of risk depending on the stage of the project.

13.4.1 Financing in the Extractive Industry supply chain

The Financing of the Extractive Industry very much depends on the Supply Chain and the kind of risks that each project needs to face. Different approaches would be

highlighted for Oil Supply Chain & Gas Supply Chain as well as on the different stage of a project.

However, the Handbook is devoted to the Upstream sector, a brief overview of the whole chain value in the Extractive sector would be provided to emphasize the difference between Upstream and Downstream in respect of finance and potential financial synergies between Upstream and Downstream (in general, investment in Upstream projects is riskier, less predictable and capital intensive than in Downstream projects).

General overview of financial issues depending on (i) Pure Exploration Projects (ii) Development of Project with Contingent Resources/Reserves and Development Plan approved (iii) Midstream & Downstream Projects.

13.4.2 Capital investment needs and decisions.

A general analysis would be offered on the factors influencing the financial decisions by companies, which basically refer to country risk and investment return.

Important to define the funding needs until the project enters into Commercial Operation with real Cash flows. “Project Internal Rate of Return (IRR)” and “Net Present Value” is critical for investors which also depends on financing structures and tax implications.

Overview on Extractive industry companies evaluating projects in term of return on capital, risks, financial structure, etc. The evaluation of CAPEX and OPEX of the project would determine the Final Investment Decision (FID) in respect of sources and users of financing.

Regulatory aspects and their potential impact on future Project Cash Flows and investment.

13.4.3 Internal and external sources of financing.

Description of sources of capital generated within the business (e.g.: equity, internal debt, shareholders loans, etc.) and of sources of raising funds which are outside the business (e.g. bank debt, market debt, export credit agencies, multilaterals, etc.).

Determination of relevant Sources and Uses of funds, its structuring as Equity/Shareholders´ Loan & Senior/Subordinated Debt, financial conditions and fiscal impact:

(i) Project and Equity IRR

(ii) Capacity of Sponsors to provide funds to the projects as needs arise.

Description of External sources of funds as Commercial Banks, Export Credit Agencies, Multilaterals and Local/International Capital Markets could be explored for a project with high Cash Flow generation and limited risks.

13.4.4 Traditional and alternative financing.

Explanation on principal ways companies in general, and Extractive Industry in particular, fund their capital expenditures. Distinction would be made between traditional sources (external loans, bonds, capital raising, internal funds, asset sales, etc.) and alternative sources (institutional support, streaming agreements, reserve base lending). Minor reference would be made to Project finance and its distinction from Corporate Finance.

Oil & Gas business traditionally is being financed directly from sponsors in the riskier stages of the Project Development Plan as Equity.

Alternatively, more complex financing schemes can be developed when there is clarity in the cash flows generation and risks are mitigated. It implies a profound study of the project looking for ways to mitigate as many risks as identified. Kind of Project Finance structures could be deployed with a sound/robust Security Package, increasing the appetite of Third Party Financiers to participate in the deal limiting the cost of financing and assurance as much as possible its repayment.

Amongst alternative financing this section may include items such as Farm in/out, overriding royalty interests, etc. We understand that one group is looking at the possibility of doing a chapter on farm in/out, so we might just mention it as a way to fund portions of the exploration/development/production phases and reference the other working being done.

Export Credit Agencies and Multilaterals with interest in regional and country development are sources of financing which interest would be explored when starting the project.

13.4.5 Distinct sources of financing over an E&P life-cycle project.

This part is aimed at providing a more in-depth analysis of financial issues in the Extractive Industry taking into consideration its special features. Purpose would be to provide an overview of the financial sources and issues in each of the different stages (phases) of a typical extractive industry project, the rationale behind and the most common financing transactions.

Would explain the role financing via debt and/or equity plays in the Upstream attending to the characteristics of each extractive phase of project life cycles due to the associated level of uncertainty. In particular, explanation why projects require significant capital over their life, but the use of debt varies significantly throughout its different stages (licensing; exploration; appraisal; development; production; abandonment; and activities to be performed after abandonment -primarily decommissioning).

Special attention would be provided to the exploration phase due to the high risk and uncertainty involved, but also to alternative approaches regarding the design of a structured finance instruments.

Chapter 13.5 Financing tax issues

Introduction of the tax risks that high non-legitimate corporate debt levels may cause from a base erosion viewpoint and the mechanism available to tackle abuses through the limitation of deductible interest.

13.5.1 Tax issues derived from the use of Debt vs. Equity.

General explanation of how the use of interest may lead to base erosion and profit shifting techniques due to the different tax treatment between debt and equity and description of the challenges faced by developing countries.

Description of the pros and cons about using debt (positive leverage) and tax (achievement of favorable tax results through the use of debt in financing projects) from a financial point of view.

13.5.2 Limitation of deductible interest based on fixed ratio tests.

Would provide a comparative between different measures to limit the deductibility of interest based on fixed ratios.

13.5.2.1 Ratio tests based on entity´s interest/earnings ratio (e.g. EBITDA)

Summary of recommendations in the design of rules to prevent base erosion through the use of interest and other payments financially equivalent to the interest expense.

Would briefly describe how Action 4 of the Action Plan on Base Erosion and Profit Shifting operates and its implementation in the European Union and other relevant countries. In addition, reference would be made to the IGF-OECD Program to Address BEPS in Mining (limiting the impact of excessive deductions on mining revenues).

Reference to specific rules established by certain countries as well as to relevant international case law.

13.5.2.2 Ratio tests based on thin capitalization rules.

Explanation and illustrative examples of country thin capitalisation legislation (debt:equity ratios). Survey of the thin capitalization rules in different countries, possibly including Mexico, New Zealand or the United States.

13.5.2.3 Interest rate caps

Explanation and illustrative examples of country legislation establishing a maximum allowable interest rate to be entitled to deduction (e.g. official interest rate index).

13.5.3 Interest withholding tax.

Tax imposed on payment of interest.

13.5.4. Other rules.

Special rules found in certain jurisdictions. E.g.: carryover of disallowed interest, notional interest, proportionate deductibility, etc.

13.5.5. Industry specific tax rules.

Reference to special rules established by certain jurisdictions in general (e.g.: proportionate deductibility) or in PSC or special rules related to Extractive Industry.

Chapter 13.6 Finance Leasing

13.6.1 Leasing in the Extractive Sector

Overview of leasing, which is not necessarily suitable for every business or for every asset purchase. In this regard, leasing is more frequently found on the Midstream (transportation) and Downstream sector, but would offer an explanation of the different types of leasing and practice in the Extractive Sector (e.g. platforms).

13.6.2 Tax implications

Analysis of Tax and Accounting treatment of the different types of leasing, as well as the advantages through capital allowances.

Chapter 13.7 Hedging

13.7.1 Risk management, financial risks & hedging policy

Overview of risk management policy and purpose of hedging. Hedging forming part of the Security package.

13.7.2 Hedging of commodities production

Explanation of hedging commodity risks; Eg: Production Break-evens

13.7.3 Hedging of financial risks

Explanation of hedging interest rates and foreign exchange rates risks; through internal and external trades.

13.7.4 Tax implications

Description of tax treatment of hedging in different relevant jurisdictions.

Consider making reference to, for example, the aggressive Tax Planning based on After-Tax Hedging (OECD report 2013).

Chapter 13 [continuation]: sub-topic on Farm In/Farm Out in Oil, Gas and Mining Activities

Intention of this Outline is to ensure developing countries understand how farm in/farm out structures are used within the extractive industry and provide an analysis of a number of tax conceptions and misconceptions around the structures. The outline below does not necessary follow the sequence that the final document may have and at present the proposal is to cover it as a [Sub]Chapter on Financing rather than be covered in one Chapter on farm ins/outs.

The [Sub]Chapter will also aim at providing practical approached by countries in dealing with farm in/farm out in the extractive industry.

Chapter 13.8 Farm in/farm out – Definition, types and common aspects

13.8.1 What is it? In Farm-in/Farm-out transactions, parties typically transfer (a part of) the license interest in a series of economic transactions where the Farmor (Vendor) transfers the (economic) interest in the asset to the Farmee (Purchaser) on the basis of a particular scheme of consideration. Farm-in/farm-out transactions can take many forms. The transaction can be influenced by the original structure of the license or the asset ownership, the residence country of the original license/asset parties, the residence country of the farmees, source country regulatory requirements etc.

13.8.2 What is it used for? Financing aspects – ownership aspects – expertise aspects – specific mining set ups/requirements

13.8.3 Common aspects and examples – 3-4 countries considering farm in/out for cash, interest, timing aspects, carry…

Chapter 13.9 Corporate income tax aspects – including capital gains tax

13.9.1 Does the transaction constitute a sale or any other taxable event?

13.9.2 What is the basis of the investment for the Farmee?

13.9.3 When is income recognized by the Farmor?

13.9.4 Is the Farmee awarded a deduction for Farm-out payments?

13.9.5 Interaction with investor country taxation: as both farmor and farmee are often foreign investors, located in different countries (as each other and as the underlying asset), it is important to consider the interaction of the tax treatment of the transaction in the source

country, where the underlying assets lies, as well as the tax treatment in the various residence countries.

Chapter 13.10 Special taxes

13.10.1 Interaction with Fiscal Take – e.g. Petroleum Income Tax

13.10.2 Others?

13.10.3 [to check for Mining special aspects]

Chapter 13.11 Transaction tax treatment

13.11.1 Stamp duties

13.11.2 VAT/sales tax treatment

13.11.2.1 For transaction itself

13.11.2.2 For future costs/carry

Chapter 15: Issues and Best Practices in Auditing Oil and Gas or Mining Activities

Intention of the chapter is to provide developing countries with the issues that are encountered during audits as well provide insights on "best" practices that can be used by officials in developing countries when auditing the extractive sector. The outline below does not necessary follow the sequence that the final chapter may have. The chapter will also be drafted in such way that it is consistent and does not overlap or duplicate with the work under the Sub-committee on Associated enterprise regarding the chapter on Audit and Risk Assessment that is in the UN TP Practical Manual for developing countries and is also undergo an update.

The chapter will also aim at providing practical examples employed by countries in dealing with issues arising from the audit of the extractive industry.

Chapter 15.1 Tax Administration arrangements

15.1.1 Pros and cons of having a dedicated office dealing with the extractive industry; mix, competence and qualification of audit staff (e.g. officials with accounting, law, mining engineering and metallurgy background);

15.1.2 Collaboration and knowledge sharing with other government agencies e.g. mining and petroleum departments, customs department.

15.1.3 Control framework and risk assessment for EI

Chapter 15.2 Industry Knowledge of EI in the Context of Audits

15.2.1 Benefits of understanding the EI by the auditing staff and tax administration in general to ensure better audit strategies and approach.

15.2.2 Knowledge on the EI value chain, cost structures, cost recovery issues in Oi and gas, mineral pricing and off-take agreements etc.

15.2.3 Use of financial market data in the context of audits – Minerals and O & G are often traded on the financial markets. A good understanding of the functioning of these markets and the quotation methods are very useful for auditing intra-group prices within MNES.

Chapter 15.3 Audit Process and Issues

15.3.1 Structure of Audit routines and Audit work plan for the sectors and benefits of having a well - structured audit process (including step by step approach guidance on the audit approach and independent review of auditor decisions).

15.3.2 Appropriate legislative framework for audit administration.

15.3.3 Information and data collection (powers to collect, penalization to mitigate or prevent delays and non - provision of audit information).

15.3.4 Risk based approach concepts and their pros and cons.

15.3.5 Post audit reporting and conclusions – (including the impact of audits/import reports on share performance of listed MNEs and the knock on thereon.

Chapter 15.4 Role of Joint Venture partners in reviewing costs particularly in the Oil and Gas industry

Chapter 15.5 Audit of Production Sharing Arrangements

Chapter 15.6 Pros and Cons of Audit Choices

15.6.1 Joint Audits,

15.6.2 Simultaneous Audits,

15.6.3 Outsourcing of Audits to consultants

15.6.4 UNDP/OECD Tax Inspectors Without Models (TIWB)

Chapter 15.7 Highlights of the benefits inherent in practices

Such as the co-operative compliance including examples of the Dutch model that is focused on cooperation and upfront communication

Chapter 15.8 Audit equipment and tools to enable efficient and effective audits

15.8.1 E-audit in the EI – how to use computer tools (including electronic audit software for bulk data) to access data on production; cross checking data reported to Tax administrations (e.g. customs, tax returns, mineral royalty returns etc.); cross checking with data in EITI

15.8.2 Use of portable scanners, cameras for audit evidence gathering on taxpayer site.

15.8.3 Subscription to EI and other data bases and institutions providing industry information on costs, commodity prices.

Chapter 15.9 Listing of possibilities that can be used for capacity building aimed at improving audit skills

15.9.1 Interviewing skills, negotiating skills, data analysis, audit skills etc.

Chapter 15.10 MNE Structures – Role of HQ and information storage.