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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.