E/C.18/2020/CRP. 50

Distr.: General 18
9 October 2020

Original: English

Committee of Experts on
International Cooperation in Tax
Matters Twentieth session
Online meeting of 20-30 October 2020
Item 3(e) of the provisional agenda Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries
Chapter XX: Tax Treatment of Subcontractors and Service Providers

Note by the Secretariat

Tax Treatment of Subcontractors and Service Providers is among the new topics for the update of the Handbook on Selected Issues for the Taxation of the Extractive Industries by Developing Countries. It is presented to the Committee FOR DISCUSSION and APPROVAL its 21st Session.

This chapter considers the taxation issues that arise from the use of subcontractors in the extractive sector. The increased complexity of extractive activities led to specialist businesses that are subcontracted by resource companies. Subcontractors open the market to more competitors, including local companies in developing countries. More competitors increase the number of bidders on projects and allows for new partnerships and operating models.

The use of subcontractors also gives rise to complex tax issues and some countries' tax administrations may have limited experience in administering these challenges. This chapter is focussed on a limited range of key tax issues specific to subcontractors engaged directly by resource companies and that are not otherwise covered in the general discussions in this Handbook.

The current version of draft chapter is quite similar to the previous version presented at the 20th Session. However, some revision have been added to improve the the overall flow of the text and to make it consistent with other parts of the Handbook. Some sections including Split Contracts, Subcontractors in the Stages of Resource Extraction, and Characterization of Income to Charge Withholding Taxes, have been substantively redrafted.

CHAPTER XX: TAX TREATMENT OF SUBCONTRACTORS AND SERVICE PROVIDERS as a NEW CHAPTER of the Handbook Draft (as of 5 October 2020)- Version 22

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XX.1. Overview

XX.1.1. Scope of chapter

This chapter considers the taxation issues that arise from the use of subcontractors in the extractive sector. The increased complexity of extractive activities led to specialist businesses that are subcontracted by resource companies. Subcontractors open the market to more competitors, including local companies in developing countries. More competitors increase the number of bidders on projects and allows for new partnerships and operating models. Additional challenges arise due to the often short duration of subcontracts that may last from a few days to a few months, which generally creates challenges on taxation in the resource state. Further, large scale long term contracts can be complex in nature, requiring a mix services performed in resource state as well as overseas. The use of subcontractors also gives rise to complex tax issues and some countries tax administrations may have limited experience in administering these challenges.

The common features of subcontracting arrangements include:

- Subcontractors generally provide specialised services at a specific stage of the project. Unlike resource companies, they generally do not invest to derive a return on the resources extracted (rather they earn a fee for services performed).
- Subcontractors supply services to multiple companies, located on different extractive sites.
- Subcontractors and the resource company they provide services to are often tax resident in different jurisdictions. Subcontractors may also not be resident in the country where the extractive site is located.
- Subcontractors services that may be entirely performed remotely in a different jurisdiction from the resource company and/or the extractive site.

This chapter is focussed on a limited range of key tax issues specific to subcontractors engaged directly by resource companies and that are not otherwise covered in the general discussions in this Handbook. General issues applicable to subcontractors but also other industry participants are not discussed.

XX.1.2. Terminology used

In this chapter:
- "EPC" means engineering, procurement, and construction.
- "EPCM" mean engineering, procurement and construction management.
- "LTU" means a Large Taxpayer Unit, i.e. a tax administration department or function focused on large taxpayers, typically defined by turnover levels, capitalization/capital employed, employee numbers, etc. criteria.
- "PE" means permanent establishment.
- "Subcontractor" means a service provider to a resource company, limited to the type of services discussed in this chapter.
- "NOC" means a National Oil Company, usually a state owned company charged with exploitation of hydrocarbons.
- "Resource company" means the concessionaire/licence holder to the resource extracted.
- "Resource state" means the jurisdiction who granted the exploration or extraction licence. While this term is used in the chapter to provide context in the extractive sector, it may be understood to be interchangeable with the term "source state" as used in discourse regarding international tax matters.
- "UNMC" means the United Nations Model Convention.
- "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. Subcontractors in the stages of resource extraction

In the extractive industries, subcontractors perform certain activities that resource companies chose to outsource. In other instances, subcontractors perform technologically advanced activities or have developed specialist technologies or expertise. Resource companies choose to outsource for a variety of commercial reasons such as to improve cost efficiencies, access technical expertise and experience and resources etc, etc.. The type of activities depend on the stage of resource extraction (as set out in Chapter 1 of the Handbook). It should be kept in mind that for oil and gas projects, the typical life cycle is between 15 to 30 years and mining projects can exceed 50 years. Subcontractors can, therefore, be long-term partners in a project.

The development of these expert service providers has had an overall positive impact, for three reasons:

- The availability of specialist service providers with specific expertise has improved the efficiency of execution of extractive projects.
- It may provide developing countries with the opportunity to develop their own resource sector through national oil companies (NOCs) or private sector extractive companies based in developing countries which then utilize specialist subcontractors to fill gaps in their areas of expertise.
- Finally, the development of these specialist providers has increased the pool of companies which can pursue extractive sector projects. Developing countries gain by having that larger pool of potential bidders for projects beyond the "majors/supermajors" and major mining companies It is however important to ensure that developing countries have appropriate transfer pricing regimes; see further XX.2.3, in case transactions take place between associated enterprises.[1] Further, developing countries are also seeking to ensure that there is more local content in the provision of services, and for development of a service sector in the extractives area.

At the at the resource contract or license negotiation stage, subcontractors can be professional firms (e.g. law firms) that advise resource companies on negotiations or firms that provide technical support to help acquire the concession. Subcontractors can also be business development partners who provide services in facilitating and maintaining the concession. It should be noted that compensation for such services are generally on a fixed fee basis; however such compensation can sometimes be on a "carried interest" basis that can, depending on the contract, result in non-cash returns. An example of this can be "end of life" projects where a specialized subcontractor with expertise in recovering resources from a depleted field can be brought in under a contract that rewards them with a set fee and bonuses based on recovery beyond what the resource company would expect the well to produce at that stage of the project. Another example in the mining sector is where a subcontractor is engaged to operate the mine ('contract mining') with a performance based component in their compensation.

At the exploration and evaluation stage, resource companies often rely on the specialized technical skills of subcontractors to evaluate the project. These skills involve technical and economic analysis, mine planning, platform design services, and geological, geophysical, and geochemical analysis using sophisticated software and technologies. Subcontractors often conduct geological mapping and surveys, seismic capture and sampling, analysis, drilling of exploratory wells or excavation services. With technological developments, many of these services can be provided remotely, without substantial need for physical presence in the resource state. Remote engagement with the resource state and the tax treatment of remote services is an evolving area, and should be analyzed in line with the approach and guidance being developed in the UNMC and its Commentary, especially UNMC Arts. 12A[2]. The resource company may also outsource local staffing, logistics support, and other ancillary services.

[1] See also the UN Practical Manual on Transfer Pricing

[2] Art 12

At the development and implementation stage subcontractors often provide procurement, engineering, construction, drilling the development wells for hyrdrocarbons and processing services to resource companies. The goods produced may relate to upstream and downstream activities and be located onshore or offshore.

At the extraction, production and exportation stage subcontractors assist oil and gas companies in production support, pipelines, transportation, byproduct processing, secondary oil recovery, and production management services. In the hydrocarbons sector, technological developments allow resource companies to increasingly manage, monitor and operate production of resources using remote sites, which may be located outside the resource state. The services to mining companies generally relate to the operation of the mine, expansion of the existing operations, and transportation. There are also ancillary services provided to resource companies in this stage, such as aviation, logistics, catering, health and safety, road construction, and habitat relocation services.

At the abandonment and decommissioning stage, subcontractors are used to remove structures and rehabilitate the extraction site. These subcontractors are generally specialised in these activities and not involved in the earlier stages of the project.

XX.2.2. Location of services provided

The different locations where subcontractors can perform their services result in tax challenges, for instance, residency status and place of supply/provision of services issues. Some of these subcontractors are small, private companies that predominantly perform their services from outside the resource state in the early stages of extraction and from inside the resource state in the latter stages. Remote supplies for outside the resource state is also possible with the introduction of new technologies. The tax challenges that arise can be further magnified since subcontractors may operate in multiple jurisdictions and provide services from multiple jurisdictions.

Using non-resident subcontractors in extractive projects is currently unavoidable in most developing countries. Although the institutional framework of developing countries may inhibit or encourage the use of resident subcontractors, the local economy often does not offer the expertise required for some activities needed for the project. For instance, the large-scale development of an underground mining project will require sub-contractors with appropriate technology and expertise. These technologies and expertise may not be available in the local market. Extractive industry contracts often include provisions for skill development and technology transfer by the resource company; developing countries may consider similar approaches for services delivered by subcontractors with appropriate tax treatment of any transfers of intangibles that may take place.

XX.2.3. Subcontractors related to resource companies

The operating models of subcontractors give rise to tax challenges. The subcontracting arrangement can either be with associated enterprises under the control of a resource company (partially or wholly) or with a subcontracter wholly independent of the resource company. If under control of the resource company, issues relating to affiliates may arise. This section is relevant for subcontractors under the control of a resource company, but essential guidance on these transaction should be sought on the application of the arm's length principle (Chapter 5) and Art 12(6) and 12A(7) of the UNMC and its Commentary.

Subcontractors who are not under the control of the resource company may nevertheless be involved in the functions, assets, and risks of a project. Under such hybrid operating models, subcontractors realise returns over a longer-term; a "life-of-field or mine" basis. It is also possible under such models that subcontractors and resource companies jointly own intellectual property that each party exploits in a different manner. Since most subcontracting entities are multinational companies, international taxation issues related to residency, transfer pricing and withholding taxes may also arise.

These complex operating models result in circumstances where developing countries need greater disclosure of information regarding transactions between subcontractors and resource companies. Tax

administrations in developing countries may, for instance, request mandatory or voluntary disclosure of such transactions from resource companies operating in their jurisdiction, e.g. where there are specific concerns about rates being offered to the resource company at a global or regional level, to enable accurate tax treatment of these transactions(see Chapter 5 and the UN Transfer Pricing Manual). (See further Chapter 5 for a list of transfer pricing issues that impact subcontractors in the extractive sector.)

XX.3. Specific tax issues relating to subcontractors

XX.3.1. Main tax issues

The gross revenues earned by subcontractors in a developing country that is the resource state may be substantial, and would be a large proportion of the capital investment made by a resource company. The tax treatment of these revenues is, therefore, important towards domestic resource mobilisation in developing countries. In principle, such non-resident subcontractors with a presence meeting or exceeding a specific threshold (e.g. a PE threshold) should only be taxed on their profits which can be allocated to such presence in the resource state, and (for VAT purposes) 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 or where the presence threshold is not met; they often rely on withholding taxes on gross income.

The main tax issues are:

- Identification of income that should be subject to tax in the resource state, generally based on source rules.
- Characterisation of income to be taxed under income tax, withholding tax, or another instrument.
- Determining the nature and location of the services performed.
- Determining the arm's length consideration for goods, services and financing where intra-group transactions are involved in the provision of subcontracting arrangements.
- Applying PE rules to subcontractors.
- Determining the place of supply and consumption for VAT purposes.
- Establishing the customs treatment of imported equipment and inputs.
- Establishing whether payroll withholding taxes apply.

These issues are discussed in this Chapter and followed by case studies on some of these issues. The challenges relate not only to tax policy issues but also to tax administration. The general principles of good tax administration are, therefore, also applicable to subcontractors, although not discussed in-depth in this Chapter. This Chapter also does not consider the general tax policy approach of developing countries regarding subcontractors. The preferred policy approach of each country would depend on its administrative capacity, institutional framework and economic environment that are different between countries.

General design principles of tax instruments apply to subcontractors - for instance balancing revenue with investment objectives - and useful guidance, specifically in regard to withholding taxes can be found in Article 12A of the 2017 UNMC. Where Article 12A applies, it should be borne in mind that the responsibility of withholding taxes may be passed through to domestic consumers. Further, a withholding tax rate higher than the foreign tax credit limit may increase the cost of investment and a high withholding tax rate on gross fees may result in an excessive effective tax rate on net income. There is also a benefit in applying the same rate to royalties and technical services to avoid tax arbitrage and classification disputes. Finally, a reduction in the withholding tax rate, or a choice to apply Article 12A in treaty policy will impact tax revenues.[3] These factors need to be balanced when setting withholding tax rates. An example of the impact of a chosen withholding tax rate is provided in XX9.4.

Apart from the main issues identified there are other technical tax issues that arise due to the use of subcontractors . This section briefly discusses issues that arise due to the use of certain complex contracts. These complex contracts require expert knowledge in tax administrations to determine their legal and

[3] See in particular, Para 32, p.333 of the Commentary to the UNMC, guidance on application of Article 12A

commercial nature and consequent tax implications. Since these are high-value contracts, they will impact cost recovery in a production sharing contract (see Chapter XX) and the value and timing of other taxes. Tax treaty and transfer pricing issues also arise due to the use of proprietary technologies and intangibles, deduction of depreciation, consideration for equipment not in use, and payment for services rendered by affiliates of subcontractors. Resolution of these issues should be guided by the Commentary to the UNMC and the UN Practical Manual on Transfer Pricing. This Chapter only outlines the nature of some key transactions and raises the tax points to be considered in the light of the above guidance.

XX.3.2. Split contracts

A key 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, as described at XX2.1. above. Split contracts are often used for services partly provided within the jurisdiction of the resource state and partly outside of this jurisdiction. 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). An example of this can be where the construction part of a project is carried out in the resource state but where the engineering design part is carried out at the foreign office of the non-resident subcontractor. There can be good reasons for doing so as discussed elsewhere, 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 to the resource state.

Two possible allocation approaches can be taken:

- Consider the entire contract while it is being performed, and determine what is carried out in the resource state, possibly by the financial year or other assessment period under domestic law of the resource state OR
- Split contracts up front and allocate a separate contract for the resource state activities. While the actual contracts are entered into by the resource company and the subcontractor, a tax administration may provide guidance on its preferred allocation approach.

. A typical example would the attribution to income in the resource state for " in country handling services" related to the delivery of the products to a client warehouse and " in country performance testing services" carried out by personnel of the subcontractor in a resource state on the drilling equipment. There would be a need to correctly identify the transactions, and address the appropriate PE and transfer pricing challenges, where associated entities were involved in the delivery of the onshore service. It is thus necessary to establish facts and circumstances of the transaction and determine the best tax treatment in line with guidance in the Commentary to the UNMC and the UN Transfer Pricing Manual. Each country should decide its own allocation approach, based on its administrative capacity and risk analysis. Splitting the contract up front can provide certainty but can be inefficient administratively, because not all the facts are known, and the activities performed when services take place may not be aligned with the original allocation.

Tax authorities in the resource state may raise queries regarding the relative pricing of the services being provided offshore and onshore, and the timing thereof, for tax reasons such as managing PE thresholds. Challenges can also arise at different levels – at the level of main subcontractor, or at the lower tiers of subcontractors. A concern for developing countries is that the resource company and its subcontractors, having more insight and control over project operations, as well as longstanding relationships distinct from a specific project, may be able to modify contract operations in split contracts including presence at operation sites. These changes limit predictability, negatively impacting the tax authority and favouring the private sector. It is also felt that the private sector, having access to financing options which cushions it from the effects of the changes in the contracts is at an advantage as opposed to the revenue authorities who are tasked with maintaining a predictable and sustainable tax system. However, such practices may be difficult to identify for tax authorities in developing countries. To the extent that the resource state relies on the approach outlined in the UNMC and its Commentary, 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. The full amount of subcontractor remuneration may be allocated to the resource state as the starting point and subsequently the actual taxation would be limited

to income which in accordance with an applicable tax treaty can be allocated to the resource state. It should also be noted that many developing countries have a small treaty network; developing countries with significant resource endowments could perhaps consider providing administrative guidance on how domestic tax law would treat split contracts.

However, where the treaty partner does not apply the same approach, split contracts may 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. Chapter 5 of this Handbook provides further guidance on transfer pricing; see XX.4.4. for additional discussion on PE issues in split contracts.

Key concerns regarding split contracts in the extractive sector can be summarized as follows:

- Whether artificially splitting one project into separate projects or artificially splitting time periods results in the avoidance of time based PE rules;
- The allocation of pricing between provision of IP vs services may result in different tax treatment, e.g. for royalties.
- Challenges in relation to identifying onshore and offshore services where the contract contains a combination of both, and where the tax law applies to them differently.

XX.3.3.Construction Contracts

The second challenge is around consideration for larger, long term Engineering Procurement and Construction ('EPC') contracts and Engineering, Procurement and Construction Management Contracts ('EPCM'). Contracts are often used for delivery of large-scale projects in the resource sector, typically at the development/construction phase or for major expansions and in the 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 risk.

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. Developing countries have expressed concerns that this type of change limits predictability, and that the private sector has an information advantage compared to the revenue authorities. Where these concerns arise, they can be addressed through clear administrative guidance with disclosure requirements on the contract and the allocation of risks therein.

While the precise nature of the contracts vary, in general they can be explained as follows:

- EPC contracts: Under an EPC contract, the contractor provides a single point of responsibility for all activities from design to procurement and construction, and will deliver a fully constructed project to the end user or owner. Unlike an EPCM contractor, an EPC contractor will perform the physical construction work. Also, under an EPC contract there will be very limited ability for the end user or owner to be involved once the contract is signed.
- EPCM contracts: Under an EPCM contract, the contractor generally provides detailed design, procurement, construction management and project coordination necessary to deliver a project. EPCM contracts are typically used for higher risk, complex projects where the contractor does not wish to be exposed to project risk and the resource company wishes to have greater control over not just what is constructed, but how it is constructed. Typically an EPCM contractor will co-ordinate and manage the construction performed by other contractors engaged by the resource company. In addition, while the EPCM contractor may provide 'procurement' services, the actual purchase of equipment and materials for a construction project may be undertaken directly by the resource company.
- Another contracting model is 'Build, Own, and Opearate' ('BOO'). These are more common for infrastructure projects such as power stations (which supply electricity to a mining project), especially where there are multiple investors and/or external finance required to develop the infrastructure. Under these contracts, the resource company is generally not the owner of the infrastructure, but rather pays for the goods or services supplied by the owner of the infrastructure. The operator of the infrastructure (often different from the resource company) will build, own and operate the infrastructure and will charge a fee to the resource company for its use or sell the output (e.g. electricity) to the resource company.

It is important for tax administrations to understand the legal and commercial nature of the different contracting models, in order to assess their tax implications. Each contract needs to be considered on a case by case basis. However, a tax administration might be unfamiliar with this type of complex contracting vehicle, and there may be legitimate concerns regarding the transparency about contract values between the resource company and the service provider. 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 guidelines 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. The case study on EPCM contracts in XX9.3 highlights the issues faced.

XX.3.4. Use of proprietary technology and intangibles/transfer pricing

There are also potential 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. In the mining sector, it is not uncommon to have contract mining operations carried out by a third party contractor or managed services contracts by mining engineering companies that are compensated at least partially based on the profitability of project; see XX.2.1 for some examples of oil/gs and mining projects of this nature. 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.

There are wider interpretative issues in dealing with questions that these new technological developments pose. Tax administrations could seek to develop a general approach in dealing with these outsourced models, informed by the requirements of domestic law and possible interpretive guidance from the United Nations Practical Manual on Transfer Pricing. 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.

In general, transactions between subcontractors and their clients, i.e. resource companies, for transfer pricing purposes, are at arm's length as they are usually between unrelated companies. Where resource companies do use related companies to provide services, or there are transactions between related companies which are both engaged in the provision of services[4] (e.g. between subsidiaries of the same MNE subcontractor where the drilling company is the contracting entity and accesses technology legally owned by a separate group entity), the guidance in the UN Practical Manual on Transfer Pricing should be consulted. It should be noted that resource companies may form a contractor group / joint venture for a given venture, and in such cases the JOA usually provides each member company with audit rights. The industry view is that this is an effective mechanism to ensure arm's length transactions. The case studies utilized in this chapter do raise some transfer pricing issues, and the possible solutions are outlined in the Case Studies section, XX.9. (See further Chapter 5)

XX.3.5.. Tax treatment of depreciation

A separate issue relates to deductions for depreciation in the case of a service provider that contends itself to have been non-resident, but 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 use of such equipment 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. Since the equipment is typically high in value, any allowable depreciation under domestic law can be material. Domestic rules may however 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; in the absence of tax relief, this will affect cost recovery and may influence investment choices.

In a different situation, 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.

The general guidance from the UN is to base the tax considerations of transfers such goods starting from book value;[5],[6] this may not cover the specific circumstances outlined above, and more detailed guidance may be necessary. Developing countries may wish to specially consider depreciation treatment, in designing administrative principles for taxation of subcontractors and service providers. Key factors in establishing accurate depreciation rules 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.

[4] Many subcontractors themselves are part of global MNE groups and have intra-group transactions.

[5] Para 18 of the Commentary to Art. 7(3), UNMC reproduces Paras 27-44 of the Commentary to the OECD Model, includes Para 33 of the latter commentary, which recommends the use of book depreciation to deal with cases of partial or temporary use (p. 232, Commentary to UNMC 2017).

[6] E.g. tax treatment of "revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset" in UNMC 2017 Comentary on Art.13, para 8 is to be guided by Art. 2.

- Appropriate taxation rules for import duties and taxes (customs, VAT/GST) for temporary importation of high value equipment into the resource state.
- 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
- Tax issues in the acquisition and disposal of capital assets, bearing in mind the guidance of the Commentary to the UNMC, to ensure that only depreciation related to the use of the asset in the resource state is allowable under depreciation rules and any non-allowable element is treated as a capital item.[7]

XX.4. PE issues in domestic law and treaties

XX.4.1. General PE issues regarding subcontractors

Chapter 3 of this Handbook provides detailed discussions on PE issues and should also be consulted, while this section focuses on specific PE issues applicable to subcontractors.

If a non-resident subcontractor has a PE in a resource state it will be liable to pay corporate income taxes in that country. Subcontractors are less likely to establish an office or other establishments in a resource state, which results in a PE, than resource companies. The general mobility and shorter period of operation of subcontractors, therefore, give rise to different PE issues than for resource companies. The period of operation of a subcontractor in a resource state may determine whether it is regarded to have a PE in that country. Specifically, the timing thresholds in the treaty, or domestic rules if no treaty applies, are relevant. This is particularly important where treaties provide for "construction PE's" and "services PE's" and the relevant activities of the subcontractor are performed in the resource state for a period in excess of the timing threshold. The timing threshold may be much lower where the resource state has an "offshore clause" in the case of activities carried out offshore in its treaty.

XX.4.2. Service PE issues.

Art 5(3)(b) of the 2017 UNMC deals with the furnishing of services, including consultancy services, through employees or personnel where "activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned". The 2011 UNMC included "for the same or a connected project" in this article and many UN model treaties contain this provision; if the time threshold is met, a PE is considered to be present. The broader scope of the 2017 UNMC means subparagraph 3(b) will apply in certain circumstances instead of the new Art 12A in relation to technical service fees.

The amendments to Art 5(3)(b) in the 2017 UNMC is relevant to subcontractors performing activities through employees or personnel in the resource state. Although certain services may be performed remotely, subcontractors generally perform activities in the resource state. They can enter into several contracts in a jurisdiction with one or more resource companies. Where the treaty relies on the 2011 UNMC, the extent that projects are connected needs to be considered. If connected, the number of aggregate calendar days of all connected projects determines whether a PE exists. In a case in India[8], the court concluded that a PE existed where a company engaged in carrying out a series of activities for three different but connected clients. One of these contracts were on-board an Indian vessel belonging to one particular client, while for another client, the subcontractor mobilized its own vessel.

[7] On the other hand, the Commentary on Art. 7, para 33, says that " where goods are…… for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material e.g. in the case of machinery, the depreciation costs that relate to its use by each of these parts."

[8] Fugro Engineering B.V. v. ACIT [2008] 122 TTJ 655 (Del)

It is also possible that a seismic survey vessel is regarded as a "fixed place permanent establishment" as, for instance, by the Indian Authority for Advance Rulings in the case of SeaBird Exploration FZ LLC.[9] If this is the case and depending on the applicable treaty, the period of activities may be irrelevant. It should be noted, however, that this an interpretation developed on the basis of Indian domestic law, and may not be consistent with the domestic law principles of other resource states.

XX.4.3. Construction PE issues.

Art 5(3) of the UNMC provides for a six-month threshold for a construction site to be regarded as a PE. The issues that arise in respect of subcontractors in relation to this clause is similar to resource companies and set out in Chapter 3.

XX.4.4. PE identification challenges from related or split contracts

Contracts may be artificially split to avoid the relevant timing thresholds that determine whether a PE exists, as, for instance, contained in Art 5(3) of the UNMC. This has been discussed above, and may trigger anti-abuse approaches by the tax authorities of the resource state. However, subcontractors may also split and sign different contracts for bona fide commercial reasons. For instance, the contracts may relate to distinct projects (either with the same resource company or with different resource companies), or the contract may be split to limit local currency exchange risks. Contracts may also be split to cover services performed in the resource state as opposed to outside of the resource state.

Since PE, withholding tax and VAT rules can differ depending on where services are performed, resource companies and subcontractors may consider it simpler to administer their tax compliance obligations by splitting contracts. Finally, contracts that involve the supply of services along with intellectual property might be split to ensure the correct tax treatment of payments which are 'royalties' and payments that are for services. Developing country tax adminstrations have valid concerns on whether contracts have been split to avoid to reduce taxation, or exposure to PE thresholds. Developing country tax adminstrations should seek to create a transparent, predicatable system for dealing with PE issues arising from split contracts which is easy for them to operate.

Action 7 of the OECD/G20 BEPS Action Plan addresses the splitting up of construction contracts. It recommends that artificial splitting should be prevented by applying a principal purpose test or by a provision that goes further and aggregates the activities of closely related enterprises on the same site during different periods of time. As an example of such a provision, Art 5(4) of the Australia – United Kingdom Income Tax Treaty (2003) states that the duration of activities "will be determined by aggregating the periods during which activities are carried on in a Contracting State by associated enterprises provided that the activities of the enterprise in that State are connected with the activities carried on in that State by its associate." Another example is contained within Art 27(a) of the Canada - United Kingdom Income Tax Treaty (1978).

The 2017 Commentary to Art 5(3) UNMCat para 11 also recognizes the risk of abuse of PE rules through artificial splitting of contracts between related companies, as outlined in the OECD Mdel Commentary, with appropriate changes. It recommends the use of an anti-abuse rule under Art. 29(9) of the 2014 OECD Model Convention, and recommends a provision, with model language, to deter such artificial splitting where the anti-abuse rule at Art 29(9) is not implemented. It further notes that several countries have implemented anti-abuse rules on this point in their domestic law.

XX.4.5. Subcontractors contracted by subcontractors.

There may be situations where a subcontractor provides only supervisory activities from a different jurisdiction than the resource state, e.g. by contracting other subcontractors to perform the actual physical

[9] A.A.R. No 1295 of 2012 of 28 March 2018. Available at http://aarrulings.in/it-rulings/uploads/pdf/1522930483_1295-seabird-exploration.pdf

activities in the resource state. In such a case, sub-subcontrators may be the ones actually performing the service at the host country and the main subcontractor just performing supervisory activities, even remotely. Since the UNMC, especially commentary on Art. 5(3)(a) includes supervisory activities under the definition of a PE, a supervising subcontractor with no physical presence may still be regarded as having a PE in the resource state, if it meets the domestic law and applicable treaty tests for a PE.[10]

XX.5. Characterization of income and withholding tax issues

XX.5.1. Charge to withholding taxes

Payments to subcontractors are often subject to withholding taxes as determined under domestic laws and treaties. Only the domestic law will apply for operations in non-treaty jurisdictions and for subcontractors operating in the resource state. In other cases a treaty will apply and the withholding tax will be influenced by whether the treaty is based on the UNMC or OECD model and the specifics of the treaty.
Art 12(5)/12A(5) of the UNMC deems royalties and technical service fees "to arise in a Contracting State when the payer is a resident of that State or if it is borne by a permanent establishment in that State". For detailed guidance to the scope of thisrule, refer to the Commentary to the UNMC, particularly Para 13 and 16 of Art 12A's Commentary.[11].

It should also be noted that Art 7 takes preference over Art. 12A where an enterprise of one Contracting State provides technical services through a PE and receives fees for those technical services within the scope of Article 12A(4). These fees could, therefore, be taxed through a profit tax, rather than a withholding tax.

XX.5.2. Characterization of income to charge withholding taxes

The meaning of royalties and technical services fees in a treaty (where a treaty exists) determines the extent that withholding taxes apply. As noted above, the UNMC provides for Arts. 12 and 12A to cover allocation rights for both royalties and technical service fees. The key phrase in this regard is whether the payments are covered by "…for information concerning industrial, commercial or scientific experience" in the definition of royalties at Art 12(3) of the UNMC. A concern raised by developing countries is the characterisation of database access fees for remote access to technologies and know-how.. If such fees could be characterised as information concerning industrial, commercial or scientific experience, they would be considered a royalty (subject to domestic law on such transactions and the language of any applicable treaty) and subject to WHT.

Where the treaty is based on the UNMC, the broader definition of these terms in the UNMC compared to the OECD model will benefit the resource state. Prior to the introduction of Art. 12A UNMC it was important to characterize payments as royalties or fees for services, owing to the different tax treatment thereof; see further para 99-103 of the Commentary to the UNMC. In general, this is now less important ; however, the specific treaty needs to be referred to in determining whether payments constitute royalties or technical service fees. [12],. Para 12, 24, 60 and 85 of the UNMC Commentary to Art 12A are of particular importance in interpreting the meaning of these terms in relation to subcontractors. Para 12 distinguishes between know-how and services, as elaborated in Para 60. Para 24 provides a narrower interpretation of technical service fees and Para 85 comments on distinguishing between technical service fees and royalties.

[10] See further Para 7, Commentary to Art. 5(3), p.156, Commentary to UNMC 2017. The para includes the sentence " (T)he Committee notes that there are differing views about whether subparagraph (a) of paragraph 3 is a "self-standing" provision".
[11] The issue of characterization of the payments of the use of such databases could give rise to questions of the application of the relevant tax treaties; this point is however not addressed here.
[12] Especially since many existing treaties at the time of writing this chapter do not have an Article based on UNMC Art. 12A

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

Services are often provided under different types of contracts using leased assets. The subcontractor can lease the equipment in the terms of a finance lease and use the equipment in the resource state, which may give rise to withholding tax on the lease payments made from the resource state. The subcontractor can also lease the equipment by an operating lease to the resource company from another jurisdiction and this may also give rise to withholding taxes. Art 12 of the UNMC includes payments for the "use of industrial, commercial or scientific equipment" within the scope of royalties; a treaty that uses the same language would allow a charge to WHT if imposed by domestic law, although Para 13.2 of the Commentary should be referred to. Guidance on whether in the case of finance lease payments are indeed made for the use of equipment falling under Art. 12 or are to be characterized as sales proceeds falling under the other articles of the treaty is provided at Para 13.3 of the UNMC Commentary on Art. 12.

XX.5.4. Computation issues and split contracts

Subcontractors may require contracts to be inclusive of the withholding tax and this carries risks of double taxation by taxing the withholding tax. This risk is reduced by domestic laws that exclude the withholding tax on this higher contract price for other tax purposes. Further issues arise where contracts include clauses that regard the subcontractor as liable for amounts of withholding tax not withheld as enforced by tax authorities. To finance this risk, subcontractors may increase their contract price. Under a production sharing contract, this may reduce the profit share of the resource state, especially in PSC regimes where this would be part of the recoverable cost structure. On the other hand, developing countries may take the view that the amount withheld is an easy to administer part of the fiscal take of the resource state, and is more transparent and certain.

All parties involved in the extractive activities may benefit from clear guidance on computational issues by tax authorities and provisions in the domestic law that reduce the risks of double taxation. To this end, Paras 14 and 15 of the Commentary to Art 12A are particularly useful. See also XX.3.2.

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

Subcontractors may use specialised ships or aircraft to provide their services. Art 12A ("fees for technical services") or Art 8 ("the operation of ships or aircraft in international traffic, or the operation of boats in inland waterways") of the UNMC may apply to these payments. Art 8 takes preference if both articles apply and the Commentary to this article provides further guidance. If neither Art. 8 nor Art 12A applies, domestic law and Arts. 5 and 7 of an applicable treaty will need to be considered, especially whether a ship constitutes a PE (as discussed in XX.4).

XX.5.6. Relief for withholding tax in the residence state

Relief for withholding taxes paid in the source state would need to be obtained from the residence state of the subcontractor. The rules governing this relief may be based on the relevant articles on withholding tax and/or Art 23A/23B in the treaty ; reference can also be made to unilateral relief rules of the residence state. It is important that tax administrations provide clear guidance on documentary and other requirements to obtain withholding certificates. Improved efficiency by tax administrations in issuing withholding certificates may increase the investment attractiveness of developing countries' extractive sectors.

XX..5.7 Relief for withholding tax in the resource state

Many resource states require provisional withholding of tax on any payment made to a non-resident for services rendered. Such withholding tax is usually considered, under domestic law, as a withholding on account of potential tax liabilities, and not the final tax of the non-resident. However, it should be noted many developing countries implement a flat withholding tax and see this as an effective tool for domestic

revenue mobilization. Where such a flat tax is imposed, there would no further relief due in the resource state and the withholding is effectively the final tax.

Where, however, WHT is considered as a withholding on account of potential tax liabilities, resource states may consider two possible solutions to provide relief:

Solution 1: Domestic tax rules in many countries may already have measures to provide such relief.This applies where the subcontractor can show that the withholding is more than its potential tax liability, either due to treaty benefits or based on a net income calculation after deduction of allowable expenses under domestic law. The withholding tax can be either reduced on the basis of a net income calculation agreed with the tax administration or refunded after provision of information as required by regulations to implement the relief regime. Further, such a regime should also consider the overall cost of compliance for withholding tax relief, which usually requires the filing of a tax return. Subcontractors have to balance the benefit from withholding tax relief and costs of tax compliance, especially in resource states where tax authorities do not provide clear guidance or have complicated documentation requirements.

Solution 2: As an alternative, a simpler solution might be to provide subcontractors resident in treaty partner states with administrative relief. Where domestic administrative rules do not already have provision for a reduced withholding certificate where the recipient of income is eligible for tax treaty benefits, the relief mechanism could be implemented by allowing such a reduction or exempt certificate to the subcontractor subject to the provision of a tax residence certificate from residence state.

XX.5.8. Withholding tax procedures

The Commentary to Art 12 and 12A of the UNMC clarify that each country can apply its own procedures in administering withholding taxes. See further XX.5.7. for a possible approach to make administrative procedures simpler for subcontractors and to reduce costs of compliance.

XX.6. Indirect taxation issues

XX.6.1. Primary VAT 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 primary VAT issues regarding subcontractors are:

- Territorial scope of the VAT: when is a supply imported or exported?
- Cross-border supplies of services and intangibles: where is a service or good supplied and consumed?
- Refunds: how can they be avoided and paid when are they due?
- VAT registration: why should suppliers be allowed to voluntary register?
- These issues are not specific to subcontractors but arise throughout the extractive sector. The questions raised are dealth in-depth in Chapter 9 of this Handbook. This chapter discusses secondary issues that are applicable to subcontractors, but less applicable to resource companies.

XX.6.2. Secondary VAT issues

The mobility of subcontractors may give rise to VAT challenges. One challenges is where subcontractors temporarily enter a country for a short-term assignment. When this happens, sub-contractors would prefer to voluntary register for VAT to be able to deduct input VAT. Registration may, however, be delayed by the revenue authority to ensure that the sub-contractor is a legitimate business and to combat fraud.

The voluntary registration rules relating to subcontractors are, therefore, important. These rules should balance the risk of fraud by businesses with the economic costs of businesses unable to register. Preliminary approval of VAT registration may also be a useful practice to reduce investor uncertainty. Related to this, VAT laws should allow for the deduction of input VAT on the first tax return after registration on capital equipment incurred before registration. Disallowing these deductions may decrease economic activity by increasing the cost of capital.

Another VAT challenge relates to the valuation of capital goods that are temporarily imported and then, after being used, re-exported by subcontractors. When importing capital goods, subcontractors will generally pay import VAT. After importation, a full input tax deduction of this import VAT will be made in most cases. As a result, the net amount of VAT paid on imports will be nil in most cases and the value assigned by customs on these imported goods is irrelevant for VAT. This result, however, requires that VAT refunds are promptly paid if they are claimed by subcontractors.

One way to avoid these refund claims without changing the VAT consequences is to allow subcontractors to defer import VAT to their first VAT return following importation. This implies that subcontractors declare import VAT in this return and deduct an equal amount of input VAT, the net effect being nil. See Chapter 9 (VAT) for more information on deferral. Where, however, the full amount of input VAT cannot be relieved, and/or the country in question does not offer VAT refunds and only allows a carry forward of VAT credit, there will be a challenge of unrelieved VAT. A further issue is the valuation of the goods for Customs purposes on temporary importation (see XX.6.4. below) and the proper application of "order of charge" for VAT purposes.

After using the imported capital goods, subcontractors can either export the goods or supply it to a domestic recipient. If capital goods are exported, the value of these goods is irrelevant since the supply will be zero-rated. If the capital goods are supplied to a domestic recipient, VAT should be charged on the value of the supply. If the recipient is not a connected person or a related party to the subcontractor (in terms of the VAT law), the value of the supply will be the amount charged on the sale. If such a person is a connected person or a related party, the value of the supply will generally be the market value of the goods. Determining this value is only important if the recipient of the goods will not only make taxable supplies but also make exempt supplies. For large capital equipment, as generally supplied by sub-contractors, it seems unlikely that the recipient will use to equipment for a purpose other than making taxable supplies and the value should, therefore, be irrelevant. It should also be borne in mind that the recipient may be non-resident and not a vendor, and the supply may be zero-rated. If, however, exempt supplies will be made by the recipient of the equipment, the tax administration would have to assess whether the value determined by the subcontractor is market-related.

VAT challenges also arise where subcontractors move capital equipment between states in a federal country. Where VAT is administered at state-level or the state and federal-level, together with the open borders between states, challenges in administering the VAT arises. Two challenges arise:

- How to ensure that only the state of final consumption receives VAT, which often requires transfers to the federal administration on inter-state supplies.
- Different tax rates may apply for supplies in and between different states.

That said, the movement of capital equipment by a subcontractor between states should not be considered a supply for VAT purposes; there should not be any VAT consequences. Only if such capital goods are sold to another person (as defined the VAT law) will there be a supply. In such cases, the supply will generally be charged with the VAT rate of the state of the recipient of the goods.

A separate VAT challenge arises where the supply can be said to have taken place in exclusive economic zones outside territorial waters of the resource states, and the question is whether the resource state has the right to levy VAT in that area. A related issue may arise in Joint Development Areas where more than one sovereign state share a development area and the charge to VAT/GST is not clarified in the JDA agreement.

Some countries also have an administrative procedure under which subcontractors are not required to pay VAT on output services which is paid by the resource companies. This breaks the chain and it would be worthwhile to consider an administrative mechanism to deal with accumulated input credits permitted under the VAT law of the resource state; measures such as a deemed credit could reduce costs for the project and/or cost of capital.

XX.6.3. Services to a head office or from staffing companies and accounting firms.

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. For VAT purposes, a single supply of a service cannot be made to more than one recipient. If it appears that there is more than one recipient, this means there is more than one supply or one recipient is acting as an agent (and the supply is only to the principal). It will, therefore, be required to identify and value the separate supplies made to the different recipients of the supplies. An invoice needs to be generated for each supply and VAT charged at the applicable rate, including zero-rate for an exported service. If the supply is to an agent, the purchase is generally deemed to be made by the principal and not the agent. The ultimate consumer of the service is the recipient of the service, even if transacted by another party.

Subcontractors may also make use of staffing companies to provide personnel. In most instances, these companies will act as the agent of the subcontractor. This means that the salaries paid by the staffing company should not be subject to VAT. A similar issue may arise where subcontractors make use of accounting firms to manage their payrolls. It is required to distinguish between the service component that is charged with VAT and the salary component for which the staffing company or accounting firm act as an agent. The principle is that supplies to or from agents retain its nature, in this case a supply of employment that falls outside of the scope of VAT in all jurisdictions.

XX.6.4. Customs duty issues

Subcontractors can face unique challenges regarding customs duties. A frequent issue is whether a country has taxing rights on imports into areas such as the exclusive economic zone or joint development area. The domestic customs duty law would determine the tax consequences in this regard. Temporary admissions of high-value exploration equipment is another challenge. Many countries refund customs duty based on the depreciated value of the temporary admitted equipment at the time of export. Clear rules governing such temporary exports by tax administrations would assist subcontractors in the industry. These rules can focus on valuation of equipment, ring-fencing of equipment, equipment sold into the domestic economy subsequent to temporary import, and related party transactions. Customs classification issues may also be reduced by allowing subcontractors to obtain advance approval, where the resource state has provision for advance rulings in its domestic law, of the classification of imported equipment.

Customs classification issues may also be reduced by allowing subcontractors to obtain advance approval, where the resource state has provision for advance rulings in its domestic law, of the classification of imported equipment. equipment. E.g., in South Africa, the Commissioner for the South African Revenue Service may in writing issue a "non-binding ruling" determining the tariff headings, tariff sub-headings or tariff items or other items of any Schedule to the Customs and Excise Act, 1964, under which inter alia any imported goods shall be classified. An importer may make an application to the Commissioner to make such a determination in respect of a specific consignment of goods imported or to be imported.

XX.7. Payroll Taxes[13]

XX.7.1. Application of payroll tax: Characterization of income received by personnel

[13] The term payroll taxes is used in this section to cover all taxes and levies on employment income. Typically, domestic laws require an employee to file a tax return, or an employer to withhold tax from the employee, or a combination of these approaches. Domestic laws may also include charges and levies payable by employers

Subcontractors regularly deploy personnel in resource states who are essential to the delivery of services. Such personnel can be part of the service contract, e.g. they operate the equipment or deliver tasks within the contractual framework for services, etc. Alternatively, the provision of staff is itself a service, i.e. a staffing service, where the provider is essentially deploying staff who work on the resource company's site and with their equipment. The specialized nature of the work involved means that 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 characterization of income received by personnel to identify whether there is a "contract of service" (i.e. an employer- employee relationship) or a contract for services (i.e. the person receiving payment does so in their capacity as an independent subcontractor) is thus an important qualification to be determined.

The first issue to consider is thus to determine whether an individual is an employee, either of a staffing company or of a subcontractor, or alternatively whether that person is an independent subcontractor (see XX.8), . An associated issue is whether, instead of a either those alternatives, the resource company itself can/should be considered the employer. This can arise e.g. where an employment agency hiring out labour to a customer in which the employment agency is the formal employer but where in substance the client/ user of the labour (the resource company) is the economic or substantive employer. The key consideration is therefore to determine whether an individual is a person who

- Has a contract of service, OR
- Has a contract for services.

An employee is a person, who under domestic law, has a contract of service, while a person with a contract for services is an independent contractor. The treatment of independent subcontractors is considered separately at XX.8.1, which also covers the treatment of personal service companies;. XX.8.2. deals with the treaty aspects including relief from double taxation. This section of the chapter focuses on individuals treated as an employee. That employer-employee relationship may arise between a subcontractor or staffing company and its employee or employees of a service provider who are considered the employee of a resource company.

XX.7.2. Application of payroll tax: Identifying the employer

The second issue to consider in the application of payroll tax 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.

Accordingly, where there is no doubt about employee status, there can still be an issue on the entity that could or should be considered the employer:

1. Where the subcontractor actually providing a service to a client via its own employee where the service provider is both the formal and substantive employer
2. Where the subcontractor is an employment agency hiring out labour to a resource company or other subcontractor. The agency is the formal employer but in substance the client/ user of the labour is the economic or substantive employer.

It is therefore useful to bear in mind that there can be three possible parties in identifying the employer in a transaction, i.e. a subcontractor, a service or staffing company which then hires out staff to the subcontractor, and finally the resource company. See further 7.4. for the tax issues that arise.

XX.7.3. Consequences of characterization and treaty application

Personnel considered to be employees can be part of the service contract, i.e. they operate the equipment, deliver tasks within the contractual framework for services, etc. Alternatively, the subcontractor can only provide a staffing service where they deploy staff (often called hire out labour) who work on the resource company's site and with the resource company's equipment. Many of these services are specialised and the charge out for personnel can often be a daily rate. Issues arise in determining whether personnel should be regarded as an employee of the subcontractor, the resource company or an independent subcontractor (the latter case being dealt with at XX.8). As mentioned above, while a formal employment contract may exist with a staffing company or subcontractor, the personnel concerned could be considered an employee of the company making use of the services under a substantive/ economic approach. This can be contrasted with staff hired out by a subcontractor (where the staff are considered employees of the subcontractor) who carry out services for the subcontractor for a resource company client.

The domestic law of the resource state often contains tests to distinguish between "contracts of service" versus "contracts for services". 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.

Detailed examination of the facts and circumstances of the arrangements are appropriate in cases where there is some question about an individual concluding a contract with a "client/employer" to provide certain services to the latter is doing so as an employee of the latter. The analysis must include a consideration of whether Art 15 would be applicable or whether treatment as an independent service provider covered by art 14 UNMC is appropriate. If the parties think it is a contract of service they assume no withholding obligations, but if the tax administration takes the view that the individual is an employee the client/employer may be subject to withholding obligations and Art 15 would apply to the salary.

Allocation of taxing rights for employees is made under Arts 15(1) and 15(2) of the UNMC. Para 8.4 of the Commentary to these Articles states that it is for the source state to characterise contracts of service versus contracts for services on the basis of its domestic law. Paras 8.5-8.9 clarify that such recharacterization may, in abusive cases, 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. Paras[14] 8.13 and 8.14 outlines a number of tests for determining the employer-employee relationship. This examination may also include whether accurate characterization as the economic employer in substance would have consequences for application of Article 15.

A further consideration is a case where an individual is to be treated as an employee, but questions arise on who can be considered the employer. This can, e.g. come up where an individual has what he or she believes to be a contract for services with a subcontractor, but where the substance leads the tax administration to conclude that the resource company is the employer. This may lead to a different interpretation of Art. 15(2) because if the formal employer (service provider or employment agency) is not considered as the economic or substantive employer but the person " hiring the labour) than the exception in Art. 15(2)(b) does not apply.

The consequences of accurate characterization can thus result in the following situations:

1. A person who has a formal contract of employment with a staffing company or a subcontractor could be considered an employee of a resource company.
2. A person who considers themselves to have self-employed status, and have a contract in that form with a subcontractor or with a resource company could be considered to be an employee of either the subcontractor or of the resource company, depending on the actual substance of the activity.

[14] 8.13 provides the first criterion whereas 8.14 mentions " additional" criteria once after the first test it seems possible that there is a substantial employer not being the formal employer.

If personnel were, based on these rules, treated as employees instead of independent contractors, or employees of a different employer for tax purposes,, large compliance costs arise. . 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, where a staffing company is involved, it may 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.These costs may also have partly have to be carried by the resource state under the cost recovery provisions of a PSC.

The result of such a determination of the relevant employer, especially in retrospective situations, can raise challenges. A subcontractor may also have left the resource state at the time of the recharacterization. The establishment of an advance ruling system on whether personnel should be regarded as employees or independent contractors as part of the administrative arrangements for extractive sector taxation. would decrease these challenges. Guidance provided by administrations to when a person is an employee, including the impact of paying day rates, can also reduce uncertainties in this regard.

XX.7.4. Employer Tax Issues

If personnel are regarded as employees, it is required to establish the entity that was their employer. This employer will have the responsibility to withhold payroll taxes. The employer is determined in terms of the domestic law of the resource state. It should be noted some countries only recognize a formal employer – employee relationship, in which case only the person having concluded the formal labour contract with the employee is considered as employer. On the other hand, other countries (as outlined in XX.7.2. above) the economic or substantive employer relationship can take precedence, where a person who is not the formal employer is responsible for all relevant responsibilities and duties of an employer.

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 the tax administration considers 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.

Depending on these rules, it may be determined that a resource company using the services of a staffing company is the employer of personnel of the staffing company. There may be some challenges in identifying which is the subcontractor and which is the staffing company. It is possible to have three parties in an assignment, i.e. a subcontractor, a service or staffing company, and finally the resource company. The staffing company hires out staff to the subcontractor who then hires out staff onwards to the resource company. The transaction could thus have two parties or may have a third one. If otherwise interpreted by the resource company, this determination may also give rise to significant compliance costs. If it is determined that the staffing company is the employer and that company is a non-resident, compliance challenges may arise since the domestic rules are designed with domestic employers in mind. Issues also arise where a subcontractor is deemed to be an employer after leaving a resource state but tax on wages was not withheld by such a subcontractor. In such cases the resource state may be unable to collect the outstanding tax from the subcontractor.

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.7.2., 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 may be is little opportunity for the employee, normally tax resident in another state, to benefit from contributions made in his/her name.

An advance ruling system with additional guidance can reduce these compliance costs. Awareness that non-resident staffing companies often require domestic accounting firms to manage their payroll and that many employees are compensated at a day rate in the industry may be reflected in this guidance.

XX.7.5. Employee tax residence

Where a person is regarded as an employee in terms of the domestic law, the tax residence status of the employee should be determined to establish the state that has taxing rights to the income derived. This depends on the residence (e.g. based on Art.4 of the UNMC) rules in the two jurisdictions and on the terms of any relevant double tax treaty. Art 15(1) of the UNMC provides for income from employment derived by a resident of a treaty state to be taxable in that state only, unless the employee carries out the employment in the other state; in the latter case the income derived from the other state will 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 three exceptions from this general rule at Art. 15(2) UNMC are

- Where the employee is present in the other state for not more than 183 days in a tax year.
- The salary is paid by an employer who is not resident in the state where the employee is working, and
- The remuneration is not borne by a permanent establishment of the employer in that other state.

Staff resident in one state and working abroad for short periods could, therefore, remain exempt 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. This may not however be applicable in most cases in practical terms. 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.

In many cases where an individual works in a foreign country for longer terms or work for a foreign employer, the treaty provisions will not prevent them becoming resident in that foreign state. The following cases might apply:

a. If the individual stays longer in another country, the person may become a resident of the other state and in case a treaty applies, the residence article of that treaty could determine that a dual residence situation exists.
b. Where the person does not become a resident of the other state, or works for an employer (formal or substantive, see above) in the other country or a PE, in which cases the exception no longer applies

Accordingly, the exemption will not apply and the state where the work is performed will have taxing rights to the income derived.. 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

The Commentary, which essentially repeats the guidance in the Commentary to the OECD Model, to Art 15 of the UNMC provides detailed guidance on these issues. It should be further noted that there are special rules regarding deemed PEs on the continental shelf in the Commentary to Art 15 of the UNMC

which impacts the usual application of Art. 15;[15] there are special rules not requiring the normal 183 day presence for taxing the salaries of personnel deployed in such a deemed PE..[16]

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.

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. 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.7.6. Computation of taxable income and other payroll tax issues

The amount of taxable income should be determined where a jurisdiction has taxing rights to income derived from employment. Determining taxable income is complicated by contracts of employment that allocate different values for work in the resource state and work in another country by the employee. Issues relating to split contracts may also arise and these include tax evasion risks. Guidance regarding thresholds to establish tax residency, procedures to show how different duties performed by employees are compensated, and guidance on the treatment of short-term employment contracts can assist tax administrations and taxpayers in this regard.

An associated issue around payroll tax is 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.

Employee related payroll tax issues may also have interplay with the visa requirements of that country. In many cases there may be a need for an employer to sponsor the employment/work visa and that may be the only visa under which a short term employee can also enter the country. Due to inter relationship between visa process and tax process these may influence each other.

XX.8. Independent subcontractors

XX.8.1. Tax issues related to independent subcontractors

Personnel working on an extractive project may be regarded as an independent subcontractor and not an employee. Such an independent contractor will be liable to pay tax in the resource state on the profits earned in that state. This tax will be payable either in his or her personal capacity or in the capacity of his

[15] As then the employee may work for a PE of his employer as meant under par.2 (letter c) of that Article

[16] Employee related payroll tax issues may also have inter play with the visa requirements of that country. In many cases there may be a need for an employer to sponsor the employment/work visa and that may be the only visa under which a short term employee can also enter the country. Due to inter relationship between visa process and tax process these may influence each other.

or her own personal service company. The administrative challenge for tax authorities is to detect disguised self-employment, especially in countries where the laws allow lower effective tax rates for independent contractors or personal service companies[17] than for employees; see 7.1/7.2. above. Anti-avoidance rules that equate these tax burdens may, therefore, assist to combat this form of tax avoidance. Such rules could include the application of a "look-through" of the personal service company via and assesing the person (owner of the service company) directly on the compensation received under the appropriate qualification of income.

Developing countries may also have concerns that independent contractor treatment could allow some private sector players to receive unintended tax benefits. Where these differences are material, a specific tax regime could be set up for independent contractors and such tax treatment notified to independent contractors at the issuance of work permits. Tax administrations in developing countries should, where the amounts at issue seem material, should set up mechanisms to detect situations where actual employment is presented as self-employment. The impact of this is receive only part of the total payment by the service company[18] as salary whereas the remaining amount may not be taxable if there is no PE in the source state. By doing so, appropriate taxation of employment income under domestic law as modified by any applicable tax treaties will be possible, and the use of personal service companies (often located in low tax jurisdictions) discouraged.

Where the individual is an independent subcontractor or working for a personal service company, the rules as set out in XX.4 and XX.5 of this Chapter applies. If the relevant treaty includes provisions similar to Art 14 of the UNMC, the income from the services performed may be allocated between two states. Where application of the PE rules is difficult, the rules of the resource state to look through the corporate structure to the individual owners of the personal service company are relevant. If these rules exist and an equivalent of Art 14 is in the relevant treaty, the resource state may tax the owners of the personal service company as if they are employees (see XX.7). Only income derived from activities in the resource state may be taxed. Similarly, countries can tax the incomes from "the independent activities of physicians, lawyers, engineers, architects….." as mentioned in Art 14. Many of these independent activities apply to the extractive industries.

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.8.2. Tax treaty issues

Para 8.10 of the Commentary to the UNMC clarifies that where a resource state recharactertises a contract for services as a contract of services under Art. 15, relief from double taxation by the resident state should still apply. Para 8.12 clarifies that any disagreements between the resource state and the residence state of the subcontractor 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 relevant in this regard.

[17] 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.

[18] The personal service company enters into a "contract for services" in form, but on examination of the substance, this may appear to be a contract of service.

XX.9. Case studies[19]

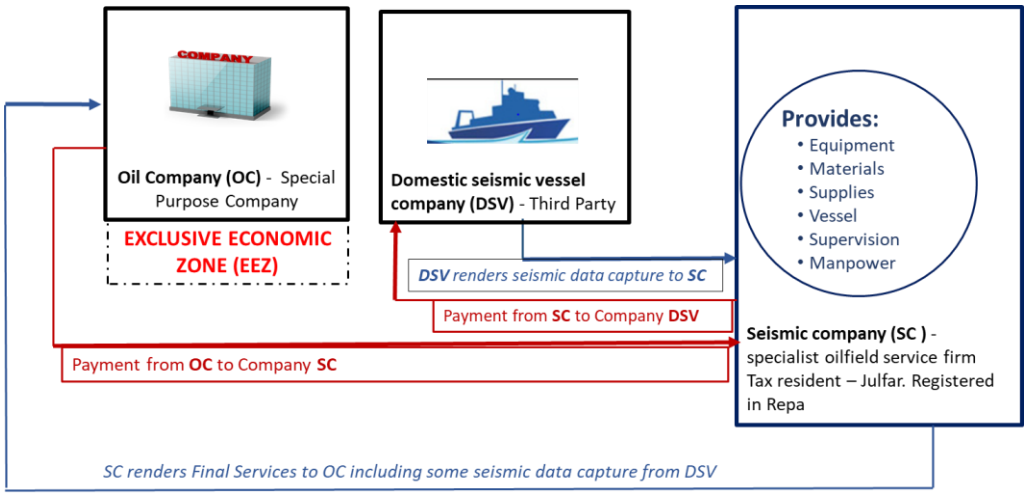
XX.9.1. Contract I – Seismic data capture and analysis

XX.9.1. Contract I – Seismic data capture and analysis

XX.9.1.1. Domestic supplies

Oil Company (OC), a special purpose entity formed in Julfar (resource state), contracts with Seismic Company (SC), a specialist oilfield service firm that is a tax resident in Julfar, to provide all necessary seismic data capture and analysis in an offshore block. The offshore block is located in Julfar and OC is the concessionaire. SC has the required expertise, combined with the ability to contract additional service firms in Julfar to perform the services in accordance with current standards and practices of the industry as set out in the contract. The contract requires that SC shall at its own cost and expense furnish supervision, personnel, equipment, materials, and supplies necessary to perform the service in a diligent manner.
In terms of the contract, OC will pay SC for the service at the time(s) and in the manner prescribed by the contract. All contract rates and other prices agreed on include any charges and provisions necessary for the completion of the contracted services. It is deemed to cover all expenses and dues, including taxes born by SC. The case is illustrated below.

In this domestic scenario there is no treaty applicable and, assuming Julfar does not administer a withholding tax on domestic supplies, SC and DSV will remit income tax to the revenue service of Julfar. This is illustrated below.

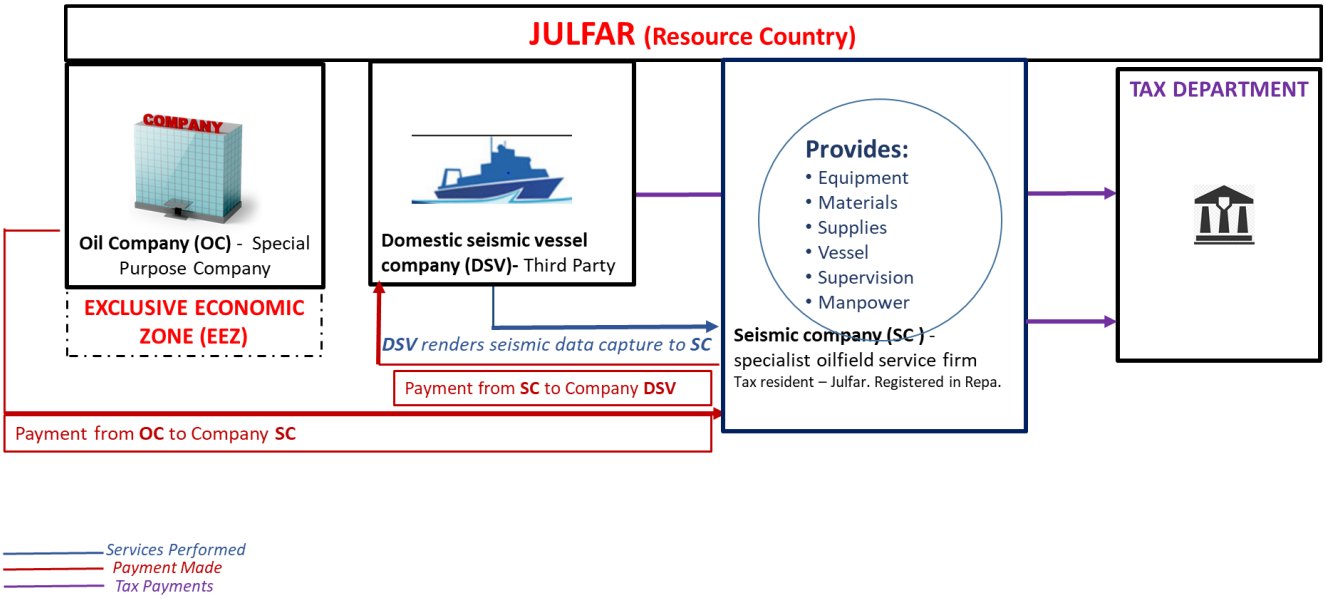


XX.9.1.2. Services delivered through a PE

Oil Company (OC), a special purpose entity formed in Julfar (resource state), contracts with Seismic Company (SC), a specialist oilfield service firm has a PE in Julfar, on the basis of a PE, to provide all necessary seismic data capture and analysis in an offshore block. The offshore block is located in Julfar and OC is the concessionaire. SC has the required expertise, combined with the ability to contract additional service firms in Julfar to perform the services in accordance with current standards and practices

[19] The case studies in this section apply the principles discussed in the previous sections to specific situations. Members of tax administrations and companies in the services sector were engaged in respect of the cases. The cases are based on three contracts and different scenarios are explored within each contract.

of the industry as set out in the contract. The contract requires that SC shall at its own cost and expense furnish supervision, personnel, equipment, materials, and supplies necessary to perform the service in a diligent manner.

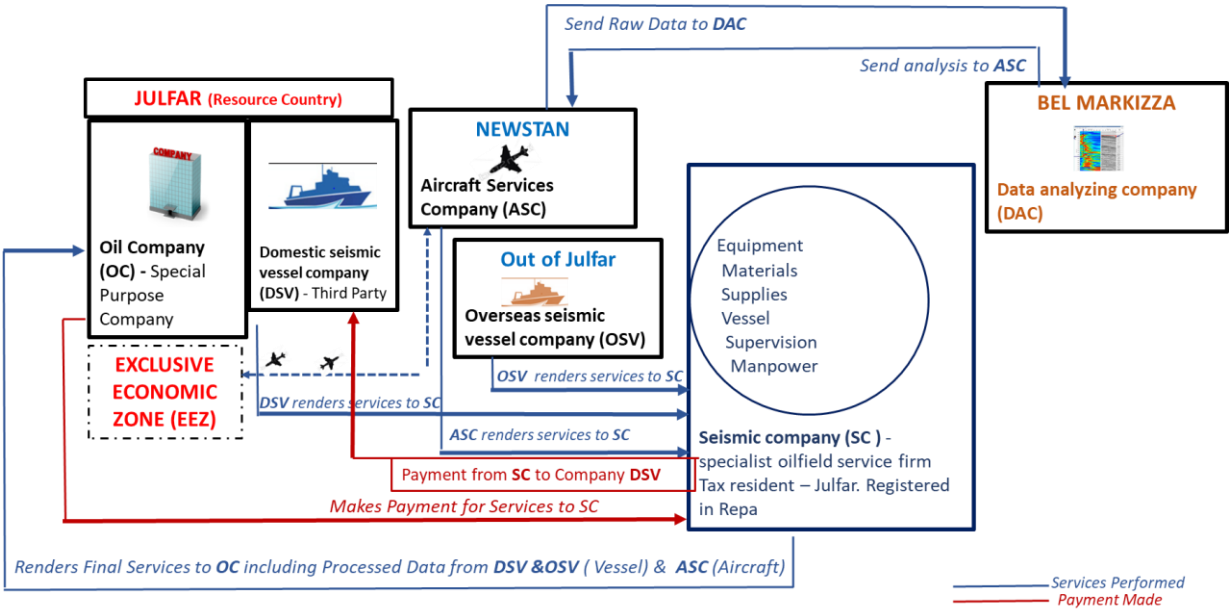


In these circumstances, the outcome is the same as as the example at XX.9.1.1

XX.9.1.3. Triangular services

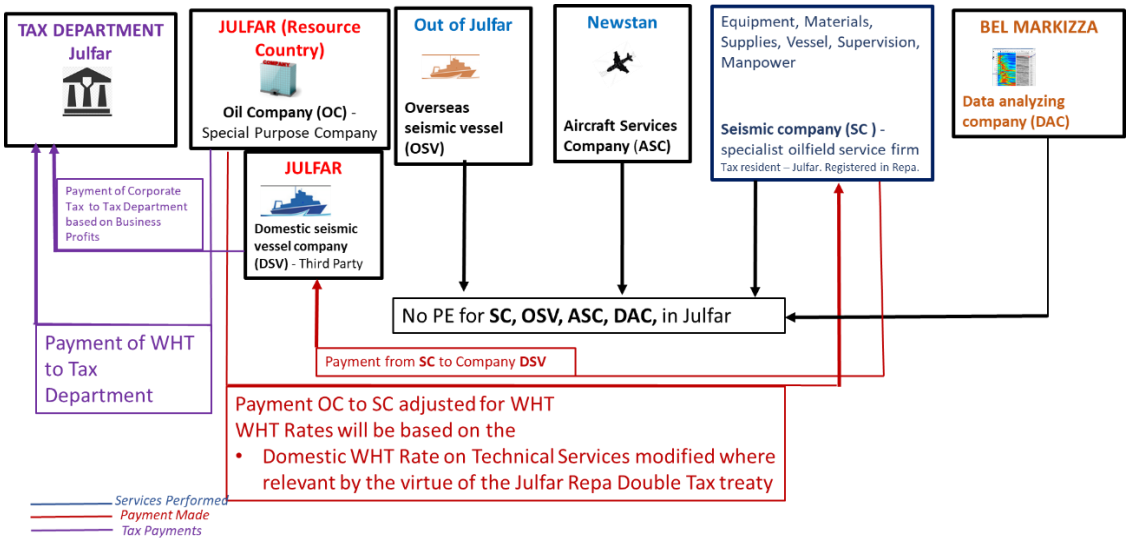
For purposes of the following discussion, all the facts of the contract as discussed above still apply. It is, however, assumed that SC is not a tax resident to Julfar, but another country named Repa.

The services in terms of the contract between OC and SC is extended and it is agreed that SC will also explore the EEZ in Julfar. SC decides to outsource some of the seismic data capture and contracts with three additional companies. The first company is Domestic Seismic Vessel (DSV) who operates in Julfar and is unaffiliated to SC. The second company is Overseas Seismic Vessel (OSV), which is based *outside* of Julfar and a related party to SC. The third is Aircraft Services Company (ASC), which is based in Newstan and unaffiliated to SC. ASC uses the latest aerial surveying technology by conducting the seismic data capture process by aircraft. The aircraft departs from Newstan, flies over the EEZ in Julfar and returns to Newstan. The data captured by ASC is sent to Data Analysing Company (DAC), a tax resident in Bel Markizza. Repa and Bel Markizza have a double tax treaty with Julfar. This case is illustrated below.



XX.9.1.4. Triangular services – no PE

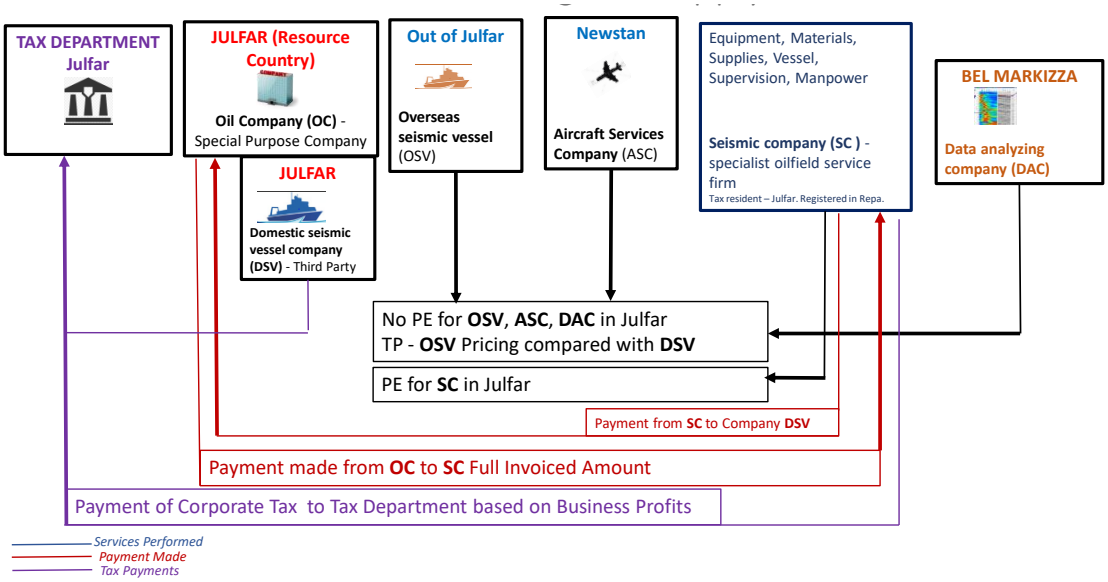
If SC has a permanent establishment in Julfar, its income will be subject to corporate income tax. The solution if this is the case is provided in the next subsection. Here it is considered that SC to not have a PE in Julfar; its income will be subject to withholding tax under the domestic law of Julfar. The facts as presented here assume that the other non-resident contractors do not have a permanent establishment in Julfar"The withholding tax rates are set out in the domestic tax law but are modified by the treaty between Julfar and Repa. The treaty places a maximum percentage on the amount of tax that can be withheld by Julfar on royalties and technical service fees; its technical service income mainly from supervision and manpower services. The withholding tax rates are set out in the domestic tax law but are modified by the treaty between Julfar and Repa. The treaty places a maximum percentage on the amount of tax that can be withheld by Julfar on royalties and technical service fees. Assuming that the definition of technical service fees in the treaty is in line with the UNMC and Repa accepts the broader approach than pure source-based, withholding tax by Julfar will apply to the entire services of the contract. This is illustrated below.



XX.9.1.5. Triangular services – PE

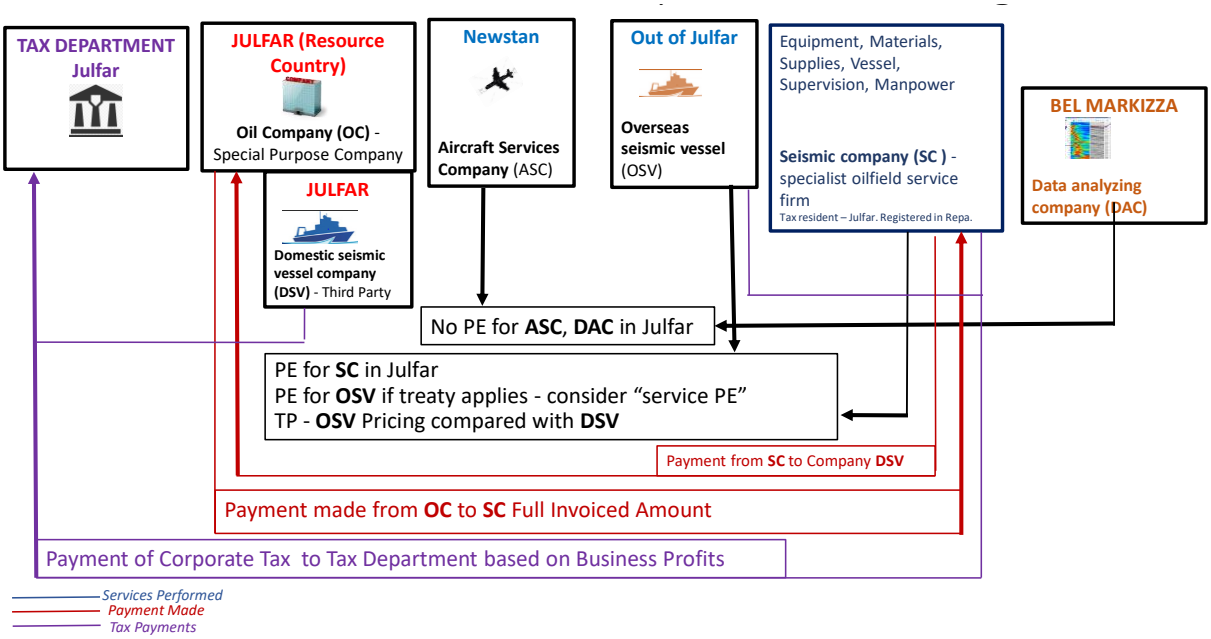
We now consider the case where SC has a PE in Julfar; SC will be liable to corporate income tax on payments from OC. A PE may normally be created if the foreign enterprise has a fixed place of business in the host country, or if it concludes contracts through a dependent agent in the host country. Some 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.

The definition of a PE will be modified by the treaty between Julfar and Repa. The treaty may also 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 Julfar. If SC requires an office or other establishments to perform the services in Julfar, SC will likely have a PE in Julfar. Also, if the performance of the seismic survey involves the presence of employees or other staff in Julfar for a period of time this could give rise to a "service PE". This is illustrated below.



XX.9.1.6. Transfer pricing

The transfer pricing discussion pertains to the triangular supply case where SC is a tax resident of Repa. The transfer price charged by DSV (a domestic third party) and OSV (a related entity) to SC should be compared. SC must ensure that the intercompany price charged by OSV to SC for similar services is in line with the arm's length principles or fully justify and substantiate any difference in price. Julfar Tax authorities would have an interest in ensuring that the pricing is at arm's length. This is illustrated below.



XX.9.1.7. VAT[20]

It needs to be considered whether SC, who provides services to OC, is registered or required to be registered for VAT in Julfar. If SC is not registered for VAT in Julfar, it may be required to do so depending on the domestic VAT law of Julfar. Registration will also depend on whether the services supplied are regarded as imported services, or services supplied from within Julfar. Alternatively stated, whether the place of supply is in Repa (imported services to Julfar) or Julfar (domestic services in Julfar). It is unlikely that registration is required if services are deemed to be imported, but the applicable law should be consulted to confirm this.

SC will be able to deduct all "Repa input VAT" paid in their tax return to the revenue service of Repa. SC will only be allowed to deduct "Julfar input VAT" paid in their tax return to the revenue service in Julfar if they are VAT registered in Julfar. VAT paid in one jurisdiction, for instance Julfar, cannot be deducted in another jurisdiction, for instance Repa.[21]

Whether SC should charge "Julfar output VAT" on the supply to OC will depend on where the service is deemed to be supplied and consumed. If the service is deemed to be supplied from outside of Julfar and not consumed in Julfar – the EEZ is deemed to be outside the VAT jurisdiction of Julfar - "Julfar VAT" will not be applicable.

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

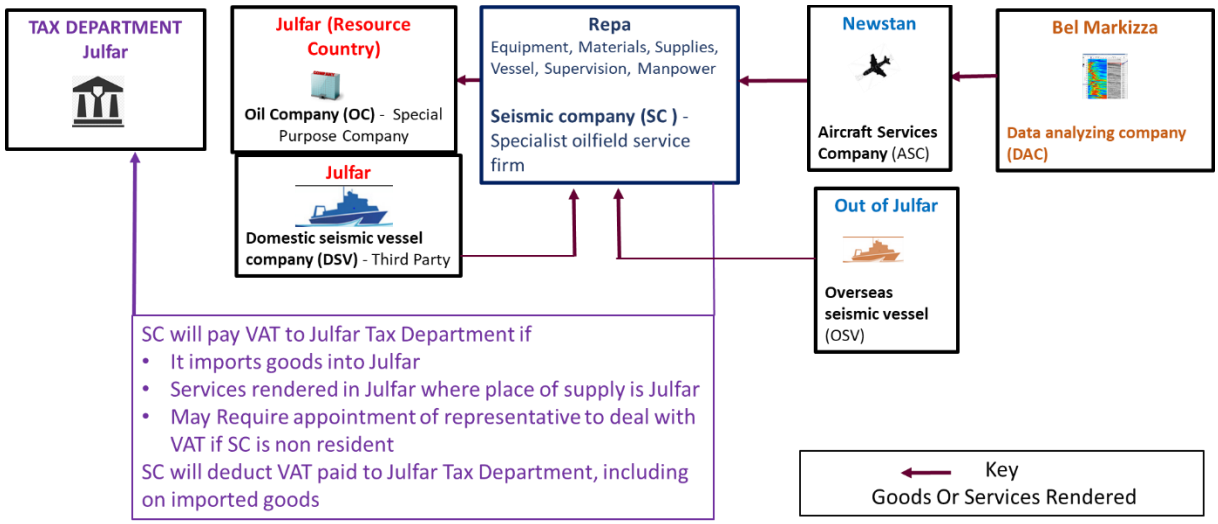
If the service is deemed to be supplied from within Julfar and consumed in Julfar, SC will likely have to register for VAT and charge "Julfar output VAT" on the supply of the service. If Julfar's legislation does

[20] The VAT consequences discussed pertains to the triangular supply case where SC is a tax resident of Repa. It is assumed that the value of the supplies of any company exceeds the VAT registration threshold in any country.
[21] It should be noted, however, that where there are mechanisms to recover such VAT (EU, the Gulf countries) even if this is not always a straight forward matter.

not require VAT registration, then no VAT is charged on the supply of the service. SC will pay import VAT on all goods imported into Jalfar and deduct this VAT in its next tax return (unless specific provisions apply that result in the imported goods not being charged with VAT).

The VAT implications for the other companies follow a similar argument to that of SC. If the place of supply of these companies services are deemed to be within Julfar or Repa, they would likely have to register and charge "Julfar output VAT" or "Repa output VAT" on their supplies to SC. The place of supply and consumption of their services will determine whether their supplies are regarded as domestically supplied or imported services. For instance, the services by DSV will be charged with "Julfar output VAT" if the EEZ is deemed to be within Julfar. If the EEZ is deemed to be outside of Julfar, no "Julfar output VAT" or any other VAT will apply. No other VAT applies since the services are not imported into another jurisdiction.

Many jurisdictions have specific place of supply rules to assist in determining the VAT consequences of inter-jurisdictional transactions. The OECD also provides useful guidelines where such rules do not exist. The VAT consequences for the transaction between SC and OC are illustrated below.



XX.9.2. Contract II- Single Point Coordinated Contracts

XX.9.2.1. Transaction details

The national oil company of Julfar (resource state), Julfar Oil Company (JOC) has a policy that limits the number of contracts that may be signed with any supplier. Only a single contract may be signed with suppliers on projects carried out in Block C (Nemr Basin) in Julfar. To not lose the single point of responsibility for a contract, JOC prefers to take a 'turnkey' position with its suppliers. Both onshore and offshore suppliers are required to enter into an overarching umbrella agreement with JOC ensuring the turnkey principle is judiciously followed.

JOC decides to contract with a third-party named Services Company (SC), a foreign entity resident in Repa, for work on Block C. SC should supply JOC with fishing equipment, and fishing[22] and side-tracking services and is responsible for all aspects of engineering, procurement, construction, installation, and commissioning. SC possesses all the necessary expertise to perform the services in accordance with current standards and practices of the industry, subject to the provisions in the contract.

[22] Fishing services are used at the Exploration, Appraisal, Development and Production stages of the field lifecycle. Fishing in this sense refers to the act of retrieving fallen items (fish) from a well or a borehole. Fishing costs may account for 25% of the total drilling costs and are a necessary part of the drilling process as well as during the life of the well through to its abandonment. See further William Lyons and Gary Plisga, *Standard Handbook of Petroleum and Natural Gas Engineering* Elsevier, 2005

SC is unable to supply the fishing equipment and with the consent of JOC contracts Domestic Product Sale Entity (DPSE), a third-party located in Julfar, to supply the equipment. To abide the JOC single contract policy, a tri-partite agreement is signed between JOC, SC, and DPSE for the supply of the equipment. In order to ensure consistent service quality and delivery of services in line with JOC standards, the supply of goods and services is at the JOC site in Block C. The delivery requires all costs to be borne by the supplier (whether domestic or foreign) to the JOC warehouse and covers the entire value of products, applicable customs duty, port handling charges, inland transportation and insurance charges up to the delivery at JOC warehouse (from hereon called "in-country handling services").[23]

As the project progresses, JOC requires drilling equipment and contracts with SC for the supply of this equipment. SC contracts with Overseas Product Sales Entity (OPSE), a related party of SC located in Newstan, to supply the equipment. The terms are the same as the previous contract and the umbrella agreement is extended to include SC, DPSE, and OPSE.

Since OPSE does not have a PE in Julfar, it prefers to sell drilling tools from Newstan to JOC through a direct sales agreement. JOC requires the delivery of drilling tools to be made to its warehouse in line with product delivery conditions. In addition to supplying the tools, OPSE must carry out performance tests locally on the drilling equipment. These performance tests can only be undertaken by OPSE personnel in Julfar. The tests will not require the OPSE personnel to remain in Julfar for a cumulative period of more than a week every year. An initial question, therefore, is consideration of the PE issues on the additional supply of customized drilling equipment through the extension of the tri-partite agreement between OPSE and JOC, and impact of PE characterization for recurrent activities.

OPSE insists that the contractual terms allow that ownership of the equipment is passed to JOC prior to the equipment entering Julfar. This would be achieved by OPSE supplying the drilling tools to JOC using the incoterm Delivery at Terminal (DAT) and will qualify as an offshore sale of products under the current Julfar legislation. The relevant "in-country handling services" required by the delivery conditions will be performed by SC in Julfar.

The price covering the offshore supply of equipment itemizes two components: the sale price for the offshore supply of equipment and the "in-country handling services" rendered in Julfar. Included in the first component, the sales price for the offshore supply is the consideration for the performance testing services on the drilling equipment.

There is a double tax treaty between Julfar and Repa, but no treaty between Julfar and Newstan.

XX.9.2.2.. Fishing equipment, and fishing and side-tracking services supplied

The supply of services is made by a tri-partite agreement between DPSE, SC, and JOC in Julfar. SC (a foreign-registered entity) through its registered PE in Julfar will pay all relevant taxes in terms of the domestic legislation of Julfar. This includes the supply of the fishing and side-tracking services and "in-country handling services".[24] The results are the same for DPSE through its registered PE in Julfar.[25]

[23] It should be noted as a general principle that the so called "incoterms" just govern the split of costs from a commercial perspective. They can support the ownership transferred outside the country, but the mere reference to the incoterms is not sufficient to establish where the sale happened. However, the reference is made only for the purposes of this particular example, and it is not meant to cover all scenarios. As a general principle, the risks and title transfer would be in the contract in addition to the incoterms.

[24] The status of SC as a foreign registered entity could also be considered; a tax treaty may apply and the application of rules would need to take this into account. However, this is not analyzed further here. The focus of the example is on a Domestic Product Sale entity and the supply under this agreement in Julfar. This comes under the heading Contract II- Single Point Coordinated Contracts. The section is not intended to extend to all of DPSE worldwide revenue steams and tax consequences.

[25] The tax implications around the supply of fishing equipment can be complex, including Customs (where such supply requires importation from outside the jurisdiction of the wells), Withholding taxes (where the individual 'fishermen' being nationals of a different jurisdiction, and where the individual permanent residence tests do not

XX.9.2.3.. Withholding tax on the additional supply of customized drilling equipment

The supply of such equipment is through the extension of the agreement between OPSE and JOC.Since the drilling tools are supplied from Newstan and there is no tax treaty between Newstan and Julfar, the domestic WHT provisions would apply. The tools are contractually an offshore sale (see further notes on PE below) so WHT should not be applied on payments from Julfar to OPSE in Newstan.

XX.9.2.4. Permanent establishment considerations

The supply of goods and services by locally registered entities has been discussed under XX.9.2.2. However, where the additional supply of customized drilling equipment PE issues may arise when this is done through the extension of the tri-partite agreement between OPSE and JOC.. For the offshore supply of drilling equipment by OPSE to JOC, the price components consist of the offshore supply of equipment, and "in-country handling services". The consequences are that the delivery and sale of the offshore equipment were made prior to the tools entering Julfar. Subsequently, payment was made by JOC to OPSE, which is in Newstan. Furthermore, the contractual terms support the conclusion that the delivery of goods was outside Julfar. Consequently, the DAT portion of the transaction should not be taxable in Julfar as the supplier is a non-resident and there is no territorial nexus of this income in Julfar.

The income of which the source is Julfar will include the "in-country handling services" and the performance testing services carried out by OPSE personnel. The relevant "in-country handling services" required by the delivery conditions will be performed by SC in Julfar and will therefore be included. The price covering the offshore supply of equipment itemizes two components: the sale price for the offshore supply of equipment and the "in-country handling services" rendered in Julfar. Included in the first component, the sales price for the offshore supply is the consideration for the performance testing services on the drilling equipment.These services are performed in Julfar, and the tax treatment in alternative circumstances are discussed below:

- Regarding the "in-country handling services", it will be taxable in Julfar based on the profits sourced in Julfar. JOC and OPSE have contractually agreed to separate this portion of the services and assign it to SC. If there is an association drawn between OPSE and SC, the tax authorities could conclude that this part of the sale transaction has been concluded in Julfar and should be taxed in Julfar. In this case the profits from the transaction must be attributed to SC on a reasonable basis. This can be a subjective attribution. An alternative would be for OPSE to contract with a third-party agent in Julfar to deliver the drilling tools to the JOC warehouse. The agent could be remunerated on a cost-plus basis and this portion of the supply will then be subject to tax in Julfar.

- Regarding the performance testing services, their consideration is not separately identified but included in the offshore sale price. A portion of the offshore sales price, therefore, has to be attributed to activities performed in Julfar and taxed in Julfar; see further XX.3.2. above.[26] The number of days that OPSE personnel visits Julfar would also have to be counted to determine whether a PE is created, based on the domestic legislation (no treaty applies). This will influence the portion of the supply liable to tax in Julfar.[27] The testing services could be taxed via corpotrate tax on Julfar locally sourced revenue. Alternatively, Julfar tax authorities could withhold tax on any payments made locally.

XX.9.2.5. Transfer pricing considerations.

Transfer pricing considerations can arise on the additional supply of customized drilling equipment through the extension of the tri-partite agreement between OPSE and JOC. The pricing of the "in-country

apply, receive payment for their services and VAT (where the equipment in question is subject to VAT and not exempted).

[26] See discussion at 3.2. above regarding split contracts.

[27] The number of days of presence in the country plays a role on determining whether a PE is created or not, but the degree to which it influences the amount attributable to the PE has to be considered with other factors.

handling services" is negotiated between SC/OPSE and a third party, JOCA. This is, therefore, an arm's length transaction and requires no further transfer pricing verification. However, if OPSE decides to use an affiliated third party agent to perform these services (to avoid the association of the offshore supply with SC), the cost-plus price that it pays the agent would require benchmarking. This benchmarking should be based on the profit margins of companies engaged in similar activities under similar circumstances.

XX.9.3. Contract III: EPCM

Mining Company (MC), a subsidiary of a multinational mining company group, holds a mining licence in Julfar (the resource state). MC has approval to develop and operate an open cut mine and processing plant on the mining licence area. MC has engaged Engineering, Procurement and Construction Managers (EM), a specialist EPCM service provider resident in Repa, to design and project manage the construction of the mine and processing plant.

Under the EPCM contract, EM will perform the following services:
- Engineering designs for the open cut mine and processing plant, which will be prepared at MC's headquarters in Repa (services outside of Julfar),
- Project management of the end-to-end construction of the plant to be undertaken in the Julfar (services in Julfar), and
- Procurement, on behalf of MC of all equipment for construction to be undertaken in Julfar (services in Julfar).

The project will take three years (one year of design and two years of construction) and during the construction phase, EM will establish a project management office (PMO) near the site. EM's overseas employees will be based at the site during this time. EM will also employ local personnel. Throughout the construction period, engineers from EM's overseas headquarters will make several short trips to the mine site in order to inspect the construction progress.

Summary of the potential tax consequences

A summary of the potential tax consequences is set out in the table below. In practice, the consequences will depend on the relevant domestic tax law and applicable tax treaty.

Activity of EM	Corporate Income Tax	WHT	VAT
Services in Julfar	There will be a PE in Julfar under Julfar's domestic law and if a Treaty applies, is likely Julfar would have the right to tax the profits of the PE – net profits subject to tax in Julfar\.	If a treaty applies, there is no WHT since there is a local PE. If a treaty does not apply there may be no WHT if PE is registered with the local tax administration. If not, WHT on gross income applies. This should be refunded against income tax paid on PE profits.	EM may be required register for VAT in the Julfar. VAT charged on supplies and deducted on inputs in Julfar. VAT refunded if required.
Services outside of Julfar	The net profits are only taxed in Repa,.	If a treaty applies, there is likely WHT on gross income (e.g. for 'technical services') – possibly at a reduced rate from the domestic rate. If no treaty applies, there is likely WHT on gross income.	VAT applicable but subject to reverse charge mechanism (no net VAT collected).
Short term visits by EM's employees	The net profits are taxed in Jufar, irrespective of whether a treaty applies.	If a treaty applies, there is no WHT since there is a local PE and the visits are connected to this PE. If a treaty does not apply there will be no WHT if PE is registered with the local tax administration. If not, WHT on gross income applies. This	EM may be required to register for VAT in Julfar. VAT charged on supplies and deducted on inputs in Julfar. VAT refunded if required.

		should be refunded against income tax paid on PE profits.	

WHT issues – services in Julfar

If there is a treaty between Julfar and Repa, there will generally not be WHT for services in Julfar on the basis that that EM has a PE in Julfar. It is not essential to apply WHT to services in Julfar provided by non-residents, as the PE rules require EM to pay tax on net profits; this is on the basis that some countries do not impose WHT on payments to PE's, in cases where the PE is registered with the local tax authority.

Developing countries will, however, often apply WHT to payments due to the challenge of ensuring compliance by non-residents even where a PE exists. In these cases the WHT would generally be creditable against tax payable on the net profit (and refundable if the WHT exceeded the tax on net profit). These challenges should be less for large EPCM service providers due to the extent of their presence in the country. Ensuring that the PE is registered, or that a local company is incorporated should also assist ensuring compliance.

WHT issues – services outside of Julfar

The payment for engineering services undertaken outside of Julfar may be subject to WHT. If EM is not resident in a country that has a tax treaty with Julfar, then the domestic rate of WHT will apply. If EM is resident in a tax treaty country (residency will be determined by the treaty) and is entitled to benefit fom the treaty, then the rate of WHT will depend on the relevant treaty. The ability to applyt the treaty may also be subject to anti-treaty abuse rules in domestic law or in the treaty, for example Art 29(9) of the UNMC. The WHT rates will depend on whether a treaty exists and WHT rates vary widely among treaties – some treaties reduce the rate to 5% or even nil. Tax authorities may implement compliance procedures to ensure the EM is entitled to apply the treaty – e.g. they may request EM provide a certificate of tax residence from the Repa tax authority in order to allow application of the treaty rate of WHT.

Given the different WHT positions for services in Julfar and services outside of Julfar, MC and EM may enter into separate contracts for these services to effectively manage tax compliance and to appropriately split the fees. The tax administration in Julfar should consider how to review the allocation between these services. This would require sufficient expertise and experience in relation to assessing the activities undertaken.

Possible variation: a local subsidiary of EM established

In some cases, MC may request that EM establish a company that is tax resident in Julfar so that all payments are to a resident company and not subject to WHT. In this case, the risk of managing WHT is transferred to the local subsidiary of EM, which will be required to pay its parent headquarters for services outside of Julfar net of local WHT. All of the same issues as above arise. However, they are managed by the EM and its subsidiary.

Establishment of local resident companies, rather than operating through a PE may also be administratively simpler for the tax administration. It may reduce the complexity of attributing a share of EM's 'profit' to the local PE. The charges between the local subsidiary of EM and MC's headquarters will, however, be subject to transfer pricing rules. If a local resident company is established, its profits would ultimately be returned as dividends to Repa and may also be subject to WHT.

PE issues – services in Julfar

EM may have a PE in Julfar based on their activities as a construction site, a fixed place of business, or an office. This would be determined in terms of the domestic law of Julfar. Under Art 5(2)(a) of the UNMC a PE specifically includes an office, and Art 5(2)(b) includes a place of management. Art 5(3) specifically includes a "building site, or construction or installation project or supervisory activities in connection herewith, but only if such site, project or activities lasts more than 6 months". EPCM will, therefore, have a PE and be required to pay income tax on profits attributable to its services in Julfar.

If a PE arises and there is a relevant treaty, the profits of the PE should not be subject to tax in Repa. Ifa treaty does not apply, double taxation should be relieved assuming that Repa's domestic tax law has a foreign branch exemption regime, or provides credit for foreign tax payable. Relief from double taxation is an important consideration for an EPCM contractor.

PE issues – services outside of Julfar

Profits from engineering services performed outside of Julfar will not be subject to a profits-based tax in Julfar. Rather, those profits will be taxed in Repa. EM and MC may, therefore, establish separate contracts for services outside of Julfar and services in Julfar. This will simplify their tax compliance obligations. Separate contracts will ensure appropriate splitting of contract prices between these services where WHT and VAT outcomes may vary. If EM established a local subsidiary in Julfar, the profits of the local subsidiary would be subject to tax in Julfar.

Short term visits by EM's employees

Short-term visits by EM's employees would generally be treated as connected to the local PE and profit from this activity should be included in the PE's net profit. If short-term visits were occurring in isolation of the construction project, a PE will generally not be created unless the time spent in Julfar exceeded a specified threshold. However, assuming that EM is not resident in Julfar, and if these services are compensated from the Julfar source, could there be WHT on such services.

VAT issues – services in Julfar

Due to the extensive activities in Julfar, EM will be required to register for VAT purposes in Julfar (assuming the registration threshold is exceeded). If registration is delayed, MC should be allowed input VAT deductions for expenses incurred prior to registration that included "Julfar VAT". Delaying registration will increase the extent of VAT refunds payable to EM upon registration. It is, therefore, important that registration is not unnecessarily delayed. When the refunds arise, this should be paid promptly, or be offset against other tax liabilities.

EM will, subsequent to registration, charge "Julfar output VAT" on its supplies to MC. MC will be entitled to an input VAT deduction of the amount of VAT paid to MC. Refunds will arise if MC is unable to offset all "Julfar input VAT" against "Julfar output VAT". Not paying these refunds promptly may result in a large disincentive in using subcontractors in the extractive sector; resource companies may rather perform the services themselves, avoiding the VAT paid to subcontractors and not (promptly) refunded by revenue services (called vertical integration). Vertical integration may lead to efficiency losses in the sector, and resource companies not using the services of local contractors, weakening the economy. Even where vertical integration does not take place, the VAT refund practice of the resource state will be factored into investment decisions. Not paying VAT refunds promptly may result in investors disregarding an investment opportunity in a specific resource state.

VAT issues – services outside of Julfar

The place of supply of the offshore engineering services is in Repa. The place of consumption of these services is, however, in Julfar. These services will, therefore, constitute exported services in Repa and imported services in Julfar. EM will deduct "Repa input VAT" for the exported services that will be zero-rated in Repa. MC will apply the reverse charge principle (if available) in Repa, meaning no VAT becomes payable on the imported service. It is, however, important that the imported services be indicated as a separate supply on the invoice from EM to MC. Not doing so may unnecessarily complicate the VAT treatment of the engineering services.

XX.9.4. The impact of the WHT rate on the cost of offshore subcontractor services

The technical expertise required on complex, large scale projects may necessarily be obtained from outside the resource state and developing country tax authorites will have legitimate concerns in relation to ensuring appropriate tax compliance, especially WHT compliance on fees for technical services. As noted above the rates of WHT on technical services vary widely and the precise level of WHT on fees for tax on technical services should take into account a number of factors including from a tax authority perspective that WHT on gross amounts of income are administratively easy to handle, and the effect that the reduction fo the WHT rates has on revenue. From the investors perspective it has been argued that high WHT rates may increase the cost of engaging sub-contractors, and therefore increase the cost of investment, as illustrated below:

For illustrative purposes, it is assumed that a subcontractor typically earns a 15% gross profit margin; for every $100 of income the subcontractor has $85 expenses and generates a $15 profit. Further, we assume that the profit tax rate is 25%. The impact of the chosen WHT rate on offshore services is illustrated below.

	WHT of 0%	**WHT of 5%**	**WHT of 20% (no gross up)**	**WHT of 20% ($20 gross up)**
Gross income	$100	$100	$100	$120
Costs	$85	$85	$85	$85
Net pre-tax profit (a)	$15	$15	$15	$35
Profit tax in residence country @ 25% (b)	$3.75	$3.75	$3.75	$8.75
WHT in resource state (c)	0	$5	$20	$24
Foreign tax credit (limited to profit tax) (d)	0	$3.75	$3.75	$8.75
Total tax in residence country (b) – (d) = (e)	$3.75	$0.00	$0.00	$0.00
Total tax (c) + (e) = (f)	$3.75	$5.00	$20.00	$24.00
After tax profit (a) – (f)	**$11.25**	**$10.00**	**($5.00)**	**$11.00**
Effective tax rate (f)/(a)	**25%**	**33.3%**	**133.3%**	**68.6%**

The example demonstrates that a high rate of WHT can result in a high effective tax rate that may result in a subcontractor making an after-tax loss. The subcontractor may attempt to shift this loss cost onto the domestic recipient of the supply. The overall cost of investment can, therefore, be significantly increased by high rates of withholding taxes.

XX.10. Other tax issues relevant to subcontractors

A range of additional issues arise in dealing with the international tax treatment of subcontractors in the extractive sector. Given the complexity of these issues, and the possible tax treatment of these matters subject to the issue of further guidance that is being developed at the global level, these are summarized below for reference purposes, and for further analysis in a later edition of the Handbook.

Risk assessment and emerging challenges	Tax treatment of transactions by and with subcontractors will be affected by growing use of intangibles, such as proprietary technologies by such businesses, and by complications from fragmentation of physical operations and business functions in digital economy. This will modify current business models away from fee from services to more risk based models. The reduced need for physical presence for the provision of services, and increasing divergence on characterisation of transactions as fees for technical services by some countries are likely to increase

	complexity in determining agreed tax treatment. Issues such as the attribution of services by nonresidents to PEs of group companies, splitting of services between related parties, connected and associated services attributed to different companies are possible areas of continuing challenges Developing countries may wish to consider developing a risk assessment format to understand possible risks to revenue from these current and emerging challenges and determine a cost effective approach for tax policy and administration in this regard.
Treatment of service companies within incentive regimes for the extractives sector	The grant of incentives for the extractive sector is covered at Chapter XX of this Handbook. Many of these issues apply equally to subcontractors. Where developing countries determine that it is appropriate to grant incentives to the extractive sector, the approach to subcontractors need to be addressed. Some key issues in this regard are: ➢ Application of incentives, if any to subcontractors ➢ The need to state the scope of any incentives – e.g. where a grant project specific exemptions or relaxations, such as customs duty exemptions on imported equipment, are granted, it is important to also provide for the limitation of use, disposal of used equipment, etc. ➢ For the mining sector, project area limitations for incentives are an important consideration to prevent abuse.
Contractor treatment in Production Sharing Contracts	There may be provisions affecting subcontractor tax in PSCs and in some cases a specific rate of withholding tax on the subcontractor or specific treatment for VAT, especially temporary admission goods, may be set out in the agreement. However, some PSC regimes are not clear on whether the subcontractor is covered under the general tax regime or under the specific PSC tax regime. The appropriate tax treatment of subcontractors should be considered in the design and drafting of PSCs, as they affect both the tax take of the resource state at the exploration and development staged, but also affect cost recovery overl the life of the project. Challenges in rules regarding the taxation of subcontractors can also translate into high development costs which may affect investment decisions.
Role of NOCs in “tax paid” PSC structures	Certain PSCs have a “tax paid” clause where the NOC undertakes responsibility for the resource state domestic corporate income tax/VAT and other applicable taxes of the resource company. This is typically then recognized in the commercial terms between the resource company and the NOC/other authority of the resource state. However, WHT application to subcontractors, and responsibility for payment of such taxes can cause administrative challenges and distort returns for the resource state.
Application of fiscal stability clauses to subcontractors	Fiscal stability clauses are quite common in extractive sector contracts; see the Government Take chapter at X. The position of subcontractors in such clauses, especially in application of WHT could raise challenges in future, especially where subcontractors are involved in the production stage with their compensation tied in whole or part to the profitability of the project.
Services delivered in special economic zones or special areas	Resource companies may be entitled to specific tax treatment in a SEZ or special exploration areas with particular characteristics. However, these measures rarely address the treatment of subcontractors; in so doing, these measures may not achieve the goals of drawing investment into that area.