

Economic &

Social Affairs

United Nations Handbook  
on Selected Issues for  
**Taxation of the  
Extractive Industries**  
by Developing Countries



United Nations



**United Nations Handbook**  
on Selected Issues for  
**Taxation of the**  
**Extractive Industries**  
by Developing Countries



United Nations  
New York, 2017



## Foreword

The United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries (the Handbook) is a response to the need, often expressed by developing countries, for clearer guidance on the policy and administrative aspects of applying taxes to enterprises, including multinational enterprises (MNEs) acting in the extractive industries and other local and international companies accessory to the business. Such guidance should not only assist policy makers and administrators in dealing with complex issues such as the quantification of the fiscal take, the costs of decommissioning, and loss of revenues derived from the indirect transfer of assets, but should also assist taxpayers in their dealings with tax administrations.

The Handbook highlights some of the issues developing countries should bear in mind when negotiating new contracts for the exploration and exploitation of natural and mineral resources within their territories. The Handbook covers the following topics in chapter order:

1. Overview;
2. Tax treaty issues;
3. Permanent establishment issues;
4. Indirect transfer of assets;
5. Transfer pricing issues;
6. The tax treatment of decommissioning;
7. The government's fiscal take;
8. Tax aspects of negotiation and renegotiation of contracts; and
9. Value added tax.

The objective of the Handbook is to focus on specific areas of interest for developing countries. The Handbook, as a product of the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Tax Committee), has a special role in reflecting the diversity of the United Nations Membership and placing taxation of the extractive industries in its developmental perspective, by exploring the challenges of taxing an industry that is of particular

relevance to developing countries, including the least developed, where extensive natural resources are often located. This recognizes both the importance to development of fair and effective tax systems, but also the fact that foreign investment, on appropriate terms, is seen as an important path to development by most countries.

Helpful guidance in this complex area must, in particular, be geared to the inevitable limitations in some countries' administrations, and deficits in information and skills that many countries are affected by in this area. Issues, in particular, of building and retaining capability as well as the need for focus and efficiency in dealing with limited resources, bear strongly on the approach taken in the Handbook. Practical examples relevant to developing countries have been especially relied upon, because the experiences of other developing countries in addressing the extractives sector are an important way of finding effective solutions that work in their context, and of doing so in the most cost and time effective ways. Examples were also drawn from developed countries, such as Norway and the United Kingdom, due to their first-hand experience in defining some of the policy approaches that are still currently applied to tax the extractive industries, and to charge national rent, also known as fiscal take.

Whereas other intergovernmental organizations have sought to provide guidance on selected tax issues for the extractive industries, such as transparency and transfer pricing approaches, the United Nations Tax Committee felt that there is insufficient analysis of the basic features which should be taken into account by any tax administration when deciding to develop policies or taxation strategies for the extractive industries. The Handbook is therefore quite unique in its aim to provide governments with a basic outline of the challenges they will encounter when seeking to compute the administrative, fiscal, environmental and other related costs of exploring natural resources—so that the economic venture does not occur at the expense of the quality of life of the citizens and environment.

This Handbook is intended to provide guidance only. It seeks to address relevant issues in the extractive industries in a clear form, to raise awareness of potential challenges and opportunities as well as the pros and cons of possible options for countries and agencies in differing positions, and ultimately to assist in making decisions on policy

and administration that are informed and reflect country realities and priorities. To the extent of any inconsistency between this Handbook and the United Nations Model Double Taxation Convention between Developed and Developing Countries, the latter prevails.

This Handbook has been the work of many authors, and particular thanks are due to the Members of the Subcommittee on Extractive Industries Taxation—Issues for Developing Countries contributing to this work. Participants included the following Members of the United Nations Tax Committee: Mr. Eric Mensah (Coordinator); Mr. Mohammed Baina (Morocco); Mr. Johan Cornelius de la Rey (South Africa); Mr. El Hadji Ibrahima Diop (Senegal); Ms. Liselott Kana (Chile); Mr. Enrico Martino (Italy); Mr. Ignatius Kawaza Mvula (Zambia); Ms. Carmel Peters (New Zealand); Ms. Pragya S. Saksena (India); Mr. Stig B. Sollund (Norway); Ms. Ingela Willfors (Sweden); and Mr. Ulvi Yusifov (Azerbaijan). Other participants were: Mr. Charles Bajungu (Tanzania Revenue Authority); Mr. Tomas Balco (Ministry of Finance of Slovakia); Mr. Rodolfo Bejarano (Red Latinoamericana sobre Deuda, Desarrollo y Derechos—Latindadd); Ms. Susana Bokobo (Repsol); Mr. Jorge Cabral (Receita Federal, Brazil); Mr. Hafiz Choudhury (M Group); Mr. Michael Durst (Attorney); Mr. Jan de Goede (International Bureau of Fiscal Documentation—IBFD); Mr. Alvaro de Juan Ledesma (Repsol); Mr. Olav Fjellså (Aker BP, Norway); Mr. Kwesi K. Obeng (Tax Justice Network Africa); Mr. Michael Kobetsky (University of Melbourne); Mr. Tomas Lassourd (Resource Governance Institute); Mr. Cephas Makunike (Tax Justice Network Africa); Ms. Nara Monkam (African Tax Administration Forum—ATAF); Ms. Nana Okoh (Gold Fields Ghana Ltd); Mr. Moises Orozco (Servicio de Administración Tributaria—SAT, Mexico); Mr. Miguel Pecho (Inter-American Centre on Tax Administrations—CIAT); Mr. Richard Stern (World Bank Group); Mr. Chris Sanger (Ernest & Young—EY); Mr. Karl Schmalz (United States Council for International Business); Mr. Brian Twomey (Reverse Engineering Services Ltd); Ms. An Theeuwes (Shell); Mr. Marius van Oordt (African Tax Institute); and Mr. Christophe Waerzeggers (International Monetary Fund—IMF). Chapter 5 of the Handbook, on transfer pricing, was prepared with extensive assistance of Mr. Joe Andrus, Ms. Melinda Brown (OECD), Ms. Monique van Herksen (Simmons & Simmons), Mr. Toshio Miyatake (Adachi, Henderson, Miyatake & Fujita), and Ms. Jolanda Schenk (Shell), all members of the

Subcommittee on Transfer Pricing. While consensus has been sought as far as possible, the views expressed in the Handbook may not reflect the understanding of all Subcommittee members.

Secretarial support for the Handbook was provided by Mr. Michael Lennard, Ms. Ilka Ritter, Ms. Tatiana Falcão and Ms. Elena Belletti. We also wish to acknowledge the assistance of Ms. Mary Lee Kortés and Ms. Leah McDavid in compiling and editing this publication, as well as the assistance of Ms. Nathalia Oliveira, Ms. Suzana Hoefle, Ms. Janaina Muller and Mr. Ahtesham R. Khan. The Subcommittee especially expresses its gratitude to the relevant ministries and agencies of the governments of Slovakia, South Africa, United Republic of Tanzania, and Zambia for generously hosting Subcommittee meetings, and also to the European Commission for financially supporting some key meetings.

Finally, it should be noted that this Handbook is conceived as a living work that should be regularly revised and improved, including by the addition of new chapters and additional material of special relevance to developing countries. This will only improve its relevance to users and its significance as a work that can be relied upon in the capacity building efforts of the United Nations and others.



## Abbreviations used

|                |                                                          |
|----------------|----------------------------------------------------------|
| <b>APA</b>     | advance pricing agreement (or arrangement)               |
| <b>ATAF</b>    | African Tax Administration Forum                         |
| <b>BEPS</b>    | the OECD/G20 Base Erosion and Profit Shifting Project    |
| <b>CCA</b>     | cost contribution arrangement                            |
| <b>CCSI</b>    | Columbia Center on Sustainable Investment                |
| <b>CFC</b>     | controlled foreign corporation                           |
| <b>CGT</b>     | capital gains tax                                        |
| <b>CIAT</b>    | Inter-American Centre of Tax Administrations             |
| <b>CIF</b>     | cost, insurance and freight                              |
| <b>CIT</b>     | corporate income tax                                     |
| <b>COP</b>     | completion of production                                 |
| <b>CUP</b>     | comparable uncontrolled price                            |
| <b>DESA</b>    | United Nations Department of Economic and Social Affairs |
| <b>DTA</b>     | double tax agreement                                     |
| <b>DTT</b>     | double tax treaty                                        |
| <b>E&amp;P</b> | exploration and production                               |
| <b>EI</b>      | extractive industries                                    |
| <b>EIA</b>     | environmental impact assessment                          |
| <b>EITI</b>    | Extractive Industries Transparency Initiative            |
| <b>EOI</b>     | exchange of information                                  |
| <b>ESHS</b>    | environment, sustainability, health and security         |
| <b>ESTM</b>    | Extractives Sector Transparency Measurement Act (Canada) |
| <b>FARI</b>    | Fiscal Analysis of Resource Industries                   |
| <b>FOB</b>     | free on board                                            |
| <b>G&amp;G</b> | geological and geophysical                               |
| <b>G20</b>     | Group of Twenty                                          |
| <b>GAAR</b>    | general anti-avoidance rule                              |

|                              |                                                                             |
|------------------------------|-----------------------------------------------------------------------------|
| <b>GDP</b>                   | gross domestic product                                                      |
| <b>GST</b>                   | goods and services tax                                                      |
| <b>IBFD</b>                  | International Bureau of Fiscal Documentation                                |
| <b>ICMM</b>                  | International Council on Mining and Metals                                  |
| <b>IEA</b>                   | International Energy Agency                                                 |
| <b>IMF</b>                   | International Monetary Fund                                                 |
| <b>IOC</b>                   | international oil company                                                   |
| <b>IP</b>                    | intellectual property                                                       |
| <b>IRPC</b>                  | profit based taxes                                                          |
| <b>IRR</b>                   | internal rate of return                                                     |
| <b>IT</b>                    | information technology                                                      |
| <b>JDA</b>                   | joint development area                                                      |
| <b>JOA</b>                   | joint operating agreement                                                   |
| <b>JV</b>                    | joint venture                                                               |
| <b>LATINDADD</b>             | Red Latinoamericana sobre Deuda, Desarrollo y Derechos                      |
| <b>LIBOR</b>                 | London Interbank Offered Rate                                               |
| <b>LIFO</b>                  | last in first out                                                           |
| <b>LLC</b>                   | limited liability company                                                   |
| <b>LNG</b>                   | liquefied natural gas                                                       |
| <b>LOB</b>                   | limitation on benefits                                                      |
| <b>MAP</b>                   | mutual agreement procedure                                                  |
| <b>MNE</b>                   | multinational enterprise                                                    |
| <b>MSS</b>                   | module support structure                                                    |
| <b>NFSL</b>                  | National Fiscal Stabilization Levy (Ghana)                                  |
| <b>NGO</b>                   | non-governmental organization                                               |
| <b>NOC</b>                   | national oil company                                                        |
| <b>O&amp;G</b>               | oil and gas                                                                 |
| <b>OECD</b>                  | Organisation for Economic Co-operation and Development                      |
| <b>OECD Model Convention</b> | Organisation for Economic Co-operation and Development Model Tax Convention |

ABBREVIATIONS USED

|                                        |                                                                                            |
|----------------------------------------|--------------------------------------------------------------------------------------------|
| <b>P&amp;A</b>                         | plug and abandonment                                                                       |
| <b>PE</b>                              | permanent establishment                                                                    |
| <b>PSA</b>                             | production sharing agreement                                                               |
| <b>PSC</b>                             | production sharing contract                                                                |
| <b>PSVs</b>                            | platform supply vessels                                                                    |
| <b>RRR</b>                             | reserves replacement ratio                                                                 |
| <b>SAT</b>                             | Servicio de Administración Tributaria (Mexico)                                             |
| <b>S&amp;T</b>                         | supply and transportation                                                                  |
| <b>SAAR</b>                            | specific anti-avoidance rule                                                               |
| <b>SME</b>                             | small and medium-sized enterprise                                                          |
| <b>TNMM</b>                            | transactional net margin method                                                            |
| <b>TP</b>                              | transfer pricing                                                                           |
| <b>UNCLOS</b>                          | United Nations Convention on the Law of the Sea                                            |
| <b>United Nations Tax Committee</b>    | United Nations Committee of Experts on International Cooperation in Tax Matters            |
| <b>United Nations Model Convention</b> | United Nations Model Double Taxation Convention between Developed and Developing Countries |
| <b>UNCITRAL</b>                        | United Nations Commission on International Trade Law                                       |
| <b>VAT</b>                             | value added tax                                                                            |
| <b>VRPO</b>                            | VAT relief purchase order                                                                  |
| <b>WBG</b>                             | World Bank Group                                                                           |



# CONTENTS

|                                                                                                  |            |
|--------------------------------------------------------------------------------------------------|------------|
| <b>Foreword</b> .....                                                                            | <b>iii</b> |
| <b>Abbreviations used</b> .....                                                                  | <b>vii</b> |
| Chapter 1                                                                                        |            |
| <b>Overview</b> .....                                                                            | <b>1</b>   |
| Executive summary .....                                                                          | 1          |
| Background .....                                                                                 | 1          |
| Industry overview .....                                                                          | 11         |
| Overview of fiscal instruments and their characteristics .....                                   | 23         |
| Other fiscal terms .....                                                                         | 25         |
| Transparency in the extractive industries .....                                                  | 28         |
| Issues for developing countries; the role of the United Nations Tax<br>Committee .....           | 29         |
| Chapter 2: Tax treaty issues .....                                                               | 30         |
| Chapter 3: Permanent establishment issues .....                                                  | 31         |
| Chapter 4: Indirect transfer of assets .....                                                     | 31         |
| Chapter 5: Transfer pricing issues .....                                                         | 32         |
| Chapter 6: The tax treatment of decommissioning .....                                            | 32         |
| Chapter 7: The government’s fiscal take .....                                                    | 33         |
| Chapter 8: Tax aspects of negotiation and renegotiation of<br>contracts .....                    | 33         |
| Chapter 9: Value added tax .....                                                                 | 34         |
| For more information .....                                                                       | 34         |
| Chapter 2                                                                                        |            |
| <b>Tax treaty issues</b> .....                                                                   | <b>37</b>  |
| Executive summary .....                                                                          | 37         |
| Background .....                                                                                 | 37         |
| Overview of the extractive industries life cycle in relation to<br>cross-border tax issues ..... | 41         |
| Personal scope of tax treaties .....                                                             | 45         |
| Substantive scope of tax treaties .....                                                          | 47         |
| Profit taxes .....                                                                               | 47         |

|                                                                  |           |
|------------------------------------------------------------------|-----------|
| Bonuses .....                                                    | 48        |
| Royalties.....                                                   | 49        |
| Production sharing contracts .....                               | 49        |
| Territorial scope of tax treaties.....                           | 53        |
| Business profits and permanent establishment issues.....         | 53        |
| Taxation of services .....                                       | 57        |
| Article 6: Income from immovable property .....                  | 60        |
| Article 8: International shipping and air transport.....         | 60        |
| Article 9: Associated enterprises .....                          | 61        |
| Articles 10, 11, 12: Dividends, interest, royalties .....        | 62        |
| Article 13: Capital gains.....                                   | 62        |
| Article 15: Dependent personal services .....                    | 64        |
| Articles 16 and 19: Director’s fees and government service ..... | 65        |
| Article 21: Other income.....                                    | 65        |
| Article 22: Taxation of capital.....                             | 66        |
| Article 23: Elimination of double taxation.....                  | 66        |
| Article 24: Non-discrimination .....                             | 67        |
| For more information .....                                       | 68        |
| <br>Chapter 3                                                    |           |
| <b>Permanent Establishment Issues .....</b>                      | <b>69</b> |
| Executive summary .....                                          | 69        |
| Purpose .....                                                    | 71        |
| Background .....                                                 | 72        |
| The basic rule of permanent establishments.....                  | 78        |
| Exceptions to the notion of PE.....                              | 85        |
| The construction work clause .....                               | 96        |
| Territorial scope of tax treaties.....                           | 106       |
| The “geographical and commercial coherence” test .....           | 110       |
| The attribution of profits to a PE .....                         | 115       |
| Services PE.....                                                 | 115       |
| Fees for technical services.....                                 | 118       |
| Examples of tax treaties that include technical fees .....       | 122       |
| For more information .....                                       | 123       |

## Chapter 4

|                                                                                         |            |
|-----------------------------------------------------------------------------------------|------------|
| <b>Indirect Transfer of Assets</b> .....                                                | <b>125</b> |
| Executive summary .....                                                                 | 125        |
| Purpose .....                                                                           | 126        |
| The issues .....                                                                        | 129        |
| Taxation of gains from indirect transfers as an option .....                            | 147        |
| The issue of symmetry .....                                                             | 156        |
| Indirect transfers and corporate structuring and restructuring. . .                     | 158        |
| What are the double-tax treaty aspects? .....                                           | 159        |
| Other approaches for taxing indirect transfers in compliance with<br>tax treaties ..... | 188        |
| For more information .....                                                              | 209        |
| Annexes .....                                                                           | 212        |

## Chapter 5

|                                                                      |            |
|----------------------------------------------------------------------|------------|
| <b>Transfer Pricing Issues</b> .....                                 | <b>217</b> |
| Executive summary .....                                              | 217        |
| Transfer pricing issues that may arise in the extractive industries. | 219        |
| Generic case examples .....                                          | 220        |
| Value chain for mining and minerals extraction .....                 | 240        |
| Industry-related case examples .....                                 | 246        |
| Value chain for the production of oil and natural gas .....          | 257        |
| Industry-related case examples .....                                 | 262        |

## Chapter 6

|                                                              |            |
|--------------------------------------------------------------|------------|
| <b>The Tax treatment of decommissioning</b> .....            | <b>283</b> |
| Executive summary .....                                      | 283        |
| Introduction .....                                           | 283        |
| Key drivers in determining decommissioning principles .....  | 285        |
| Approach to a tax policy framework for decommissioning ..... | 288        |
| Contract structures and fiscal regime design .....           | 289        |
| The broad decommissioning regime .....                       | 289        |
| Decommissioning principles .....                             | 289        |
| Choosing who is responsible and who should pay .....         | 291        |
| Funding decommissioning .....                                | 292        |

|                                                                      |            |
|----------------------------------------------------------------------|------------|
| Basic tax choices: an overview of the common models . . . . .        | 293        |
| General questions: measuring the costs of decommissioning . . . . .  | 301        |
| Implications of security . . . . .                                   | 303        |
| Tax policy legislative design . . . . .                              | 304        |
| Potential impacts of various tax issues on decommissioning . . . . . | 304        |
| Annexes . . . . .                                                    | 311        |
| Chapter 7                                                            |            |
| <b>The Government’s Fiscal Take . . . . .</b>                        | <b>343</b> |
| Executive summary . . . . .                                          | 343        |
| Purpose . . . . .                                                    | 344        |
| Background . . . . .                                                 | 345        |
| Risk/return . . . . .                                                | 345        |
| No “one size fits all” . . . . .                                     | 347        |
| Predictability . . . . .                                             | 348        |
| Long-term perspective . . . . .                                      | 349        |
| Simplicity and clarity . . . . .                                     | 350        |
| Scope . . . . .                                                      | 350        |
| Stakeholder considerations . . . . .                                 | 351        |
| Resource holder considerations . . . . .                             | 352        |
| Investor considerations . . . . .                                    | 355        |
| Building blocks for government share . . . . .                       | 357        |
| Contractual arrangements . . . . .                                   | 359        |
| Concessionary systems . . . . .                                      | 360        |
| Contracts . . . . .                                                  | 360        |
| Service contracts . . . . .                                          | 363        |
| Fiscal instruments . . . . .                                         | 364        |
| Profit-based fiscal instruments . . . . .                            | 367        |
| Production-related taxation . . . . .                                | 370        |
| Specific arrangements . . . . .                                      | 370        |
| Indirect tax . . . . .                                               | 372        |
| Timing of revenue . . . . .                                          | 373        |
| Overall objectives . . . . .                                         | 374        |
| Progressivity versus regressivity . . . . .                          | 375        |



|                                                                                      |            |
|--------------------------------------------------------------------------------------|------------|
| Issues of interaction . . . . .                                                      | 378        |
| Delineation issues . . . . .                                                         | 378        |
| Interdependency . . . . .                                                            | 379        |
| Interaction between extractive industries taxation and general<br>taxation . . . . . | 379        |
| Relevance of subnational taxation and allocation of revenues . . . .                 | 381        |
| Issues of enforcement . . . . .                                                      | 381        |
| For more information . . . . .                                                       | 382        |
| Chapter 8                                                                            |            |
| <b>Tax Aspects of Negotiation and Renegotiation of contracts . . . . .</b>           | <b>385</b> |
| Executive summary . . . . .                                                          | 385        |
| Background . . . . .                                                                 | 385        |
| Interrelationship with other chapters of the Handbook . . . . .                      | 387        |
| Negotiation background: country perspectives . . . . .                               | 387        |
| Negotiation background: investor perspectives . . . . .                              | 404        |
| Investment phases . . . . .                                                          | 413        |
| Some practical aspects of successful negotiations . . . . .                          | 415        |
| Other contract negotiation issues . . . . .                                          | 416        |
| Achieving a Good Deal: Fiscal Regimes for Oil, Gas and Mining .                      | 422        |
| Contract renegotiation issues . . . . .                                              | 423        |
| Conclusions . . . . .                                                                | 432        |
| For more information . . . . .                                                       | 434        |
| Chapter 9                                                                            |            |
| <b>Value added Tax . . . . .</b>                                                     | <b>437</b> |
| Executive summary . . . . .                                                          | 437        |
| Purpose . . . . .                                                                    | 441        |
| VAT policy and administration in the extractive industries . . . . .                 | 445        |
| <b>Glossary . . . . .</b>                                                            | <b>467</b> |



# Chapter 1

## OVERVIEW

### Executive summary

The purpose of this chapter is to give an overview of some of the taxation issues for extractive industries in developing countries and the interactions between them, as well as options available, and the likely effect of choosing such options in particular circumstances. This is intended to assist policy makers and administrators in developing countries as well as to provide information to other stakeholders. Background contained in this chapter will provide a broader context for viewing the overall issue of natural resource development and the specific issues addressed in more detail in additional chapters.

The work covered by this and each of the additional specific-issue chapters stems from a mandate given by the United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Tax Committee) to the Subcommittee on Extractives Industries Taxation Issues for Developing Countries to consider, report on and propose guidance on extractive industries taxation issues for developing countries, focusing on the most pressing issues where guidance from the United Nations Tax Committee may most usefully assist developing countries. The work will seek to provide policy and administrative guidance at a very practical level.

This chapter is intended to broadly identify issues of taxation of the extractive industries; address several of the most significant ones in short form; help build awareness; and, ultimately, along with the additional specific-issue chapters, assist those faced with these issues to make policy and administrative decisions in relation to them.

### Background

Extractive industries are engaged in finding, developing, producing and selling non-renewable natural resources such as crude oil, natural gas and mining products.<sup>1</sup> The extractive industries are an important

---

<sup>1</sup> Crude oil and natural gas are key energy resources, as well as inputs to

sector and thus a potentially important revenue base in many developing countries and emerging economies. Given projections that by 2040 world population will grow by 2 billion persons and per capita gross domestic product (GDP) will double, the International Energy Agency (IEA) forecasts that the world's energy requirements will increase by almost one third by 2040. While the growth rate of renewable energy supplies will far exceed that of conventional fuels, and energy efficiency improvements will be substantial, the IEA projects that oil and natural gas demand will increase by 12 per cent and 49 per cent, respectively, compared to 2014 levels. Coal demand is also expected to rise (by 5 per cent) over the same timeframe such that these three fuels, without other additional significant breakthroughs, will account for approximately 74 per cent of world energy needs in 2040 (down from approximately 81 per cent in 2014).<sup>2</sup>

The IEA also recently forecast that to meet the increased energy needs of the world, \$68 trillion of new investment will be required by 2040.<sup>3</sup> The IEA projected nearly two thirds of energy-related investment to be in emerging economies.<sup>4</sup> This presents major challenges, but also significant economic development opportunities.

With minerals playing crucial roles throughout economic sectors, especially in agriculture, construction, energy, transportation, electronics, and medicine, the projections for population, economic and energy growth translate into increased demand for minerals. For example, steel demand could potentially exceed 2010 levels by 120 per cent in 2040, with the greatest increase being in emerging economies.

---

other worldwide products, such as chemicals, plastics, and fertilizers. Hard minerals comprise a wide variety of products, such as copper, iron, gold, bauxite and numerous rare earth minerals, which are also used as inputs for many essential products, such as steel, aluminum, plastics, and fertilizers.

<sup>2</sup> See International Energy Agency, *World Energy Outlook 2016*. Available at <https://webstore.iea.org/download/direct/202?fileName=WEO2016.pdf>. All amounts are based on the New Policies Scenario in the Outlook, which reflects the Paris Agreement that became effective in November 2016, with certain adjustments.

<sup>3</sup> See International Energy Agency, *World Energy Outlook 2015*. Available at <http://www.iea.org/publications/freepublications/publication/WEO2015.pdf>.

<sup>4</sup> See International Energy Agency, *World Energy Outlook 2014*. Available at <http://www.iea.org/publications/freepublications/publication/WEO2014.pdf>.

Similar results are projected for copper.<sup>5</sup> The International Council on Mining and Metals (ICMM) has underscored the significance of regions with emerging economies, noting the large investments that were recently undertaken in Latin America, Africa and parts of Asia, and the outlook that these will likely increase in the next 10 years.<sup>6</sup>

Against this macroeconomic backdrop, a political, financial, monetary, and legal stability, as well as a labour market-fiscal stability, are crucial in developing countries' efforts to attract foreign direct investment in the extractive industries to contribute to mobilizing domestic resources for development. While resource development will be needed to meet worldwide energy demand and foster economic growth, the extractive industries are and will increasingly become an important sector in many developing countries and emerging economies. Not only will the direct investment that such industries generate be an important contributor to economic development, it will also provide a broader and potentially important, revenue base for additional economic development that countries may wish to pursue.

The tax and broader fiscal system that applies to the extractive industries should ensure that the government obtains an adequate and appropriate share of the benefits from its resources—taking into account that extractives are assets owned by the country and once extracted, they are gone—while providing a return commensurate with the risks borne and functions carried out by the parties. Tax laws and regulations that provide legal certainty and stability reduce financial risk and therefore aid in attracting investment. In addition, transparent administration of the tax system and the avoidance of double taxation further reduce risks and influence investment decisions in the extractive industries. Governments should seek to balance creating or sustaining a supportive environment for large investment with the country's need for revenue streams that can be applied to their development efforts. Close collaboration among different governmental agencies, including

---

<sup>5</sup>See K. Keramidas, A. Kitous and B. Griffin, *Future availability and demand for oil gas and key minerals*, p. 45. Available at <http://www.eisourcebook.org/cms/February%202016/Future%20availability%202012.pdf>.

<sup>6</sup>See International Council on Mining and Metals, *The role of mining in national economies*. Available at [https://www.icmm.com/website/publications/pdfs/social-and-economic-development/romine\\_1st-edition](https://www.icmm.com/website/publications/pdfs/social-and-economic-development/romine_1st-edition).

ministries of energy and mining, environment, finance, tax policy and administration, along with those entrusted to govern, manage, or reinvest revenues from natural resource development, is important in arriving at the correct balance at the outset and on an ongoing basis.

The extractives industries are unique in many ways: the sector is shaped by high sunk costs in the form of substantial investments that cannot be recouped if a project is unsuccessful; long lead times from initial investment to project start-up and very long production/project lives; fluctuating costs and commodity prices that in turn influence the profitability of exploration, development and extraction; volatile demand; and environmental impacts, including ultimately ‘decommissioning’ or reclamation responsibilities.<sup>7</sup> The extractive industries are often located in remote areas, at great distance from their eventual markets. At the same time, companies active in the extractive industries have the potential of substantial earnings in excess of the return on investment required to induce their acceptance of the risks they assume (i.e. windfall gains).<sup>8</sup>

Given the large capital investment required to develop and produce natural resources, and the fact that the output is also physically present in the source country, often with world market benchmark prices available, the risk that the product sales value cannot be validated by tax authorities may be lower than for some other non-commodity-based businesses. Similarly, particularly in the petroleum industry where joint ventures are present, goods or services charged into the venture by the operator are generally required under industry practice to be at cost and subject to audit by the co-venturers.<sup>9</sup> Thus, base erosion and profit shifting techniques

---

<sup>7</sup>For a more complete list of the risk factors investors face, see International Energy Agency, *World Energy Investment Outlook 2014, Special Report*, p. 32, Table 1.4 “Categories of risk facing an energy investment project”. Available at <https://www.iea.org/publications/freepublications/publication/WEIO2014.pdf>.

<sup>8</sup>See L. Burns, *Income Taxation through the Life Cycle of an Extractive Industries Project*, Asia-Pacific Tax Bulletin, vol. 20, no. 6 (18 November 2014), p. 401.

<sup>9</sup>Jack Calder, *Administering Fiscal Regimes for Extractive Industries: A Handbook* (Washington, D.C: International Monetary Fund, 2014), p. 80.

may differ as compared to other sectors. Nevertheless, given the large production values and associated development and production costs, there is growing concern about the erosion of the source country tax base via aggressive tax planning strategies, and thus fiscal regime design and administration procedures and practices should properly address these issues.

Governments will likely want to tailor their auditing plans and efforts based on the natural resource activities and parties involved, evaluating the potential risks presented and benefits to be gained from specific enforcement actions. While the challenges of dealing with these issues are the same for all natural resource countries, under-resourced and overstretched tax administrations in developing countries are often not as well equipped to deal with them. They may need augmentation, additional training, and capacity building as extractive industries activities commence, or significantly increase, in order to deal with them effectively. The information and knowledge needed to design and administer appropriate tax rules that apply to the extractive industries may be lacking or very thinly spread locally. Coordination between different parts of the government often proves challenging. Due to a lack of funding that often exists, access to specialists in tax design and administration is often asymmetrical as between multinational companies and developing countries.

In designing an overall taxation regime and developing its administration, each country must carefully determine its priorities and consider a wide array of choices available to it. There are numerous issues it must deal with, and the approach on any particular issue may not be the same across countries. Ultimately, it is recommended that each country develop its own set of principles and goals, tailoring these to its specific priorities and to its unique circumstances (including location and quality of the natural resources to be developed, infrastructure, political and economic climate, development needs, and other resources available in country). Two examples, one from a country and the other from an investor perspective, are shown in boxes 1 and 2 to illustrate possible approaches that can be taken in developing principles and development goals. Once a country determines its own set of principles and goals, the choices it makes in its taxation system design, including the structure and administration of taxation, other fiscal terms, and legal/regulatory requirements, should

be tested to determine whether they advance and are consistent with those objectives.

To summarize, some reoccurring issues that countries face are summarized below. They underscore the interests that a country will need to balance, such as

- Attracting foreign or domestic direct investment in the extractive industries;
- Ensuring the government receives an appropriate share of revenues;
- Weighing timing issues in relation to receipt of revenue;
- Ensuring sound environmental policies and protections exist;
- Fostering the development of local capacity in providing goods and services to the extractive industries;
- Reconciling transparency, and confidentiality; and
- Designing appropriate governance rules for the extractive industries, including capacities to deal with potential corruption.

Additionally, as revenues are generated under the fiscal plans, management of such funds over the short and long-term requires planning, diligence, and governance structures.

Box I.1:

**Investment principles and goals: country perspective:**

**Mozambique Natural Gas Master Plan<sup>a</sup>**

In June 2014, the Cabinet Council of the Republic of Mozambique adopted a comprehensive plan for the development of its natural gas resources to “maximize the benefits to Mozambican society, in order to improve the living standards of its population, while minimizing the negative environmental impacts”.<sup>b</sup>

The Natural Gas Master Plan focuses on three pillars for development: economic and institutional, financing and tax, and environmental and social development, as summarized in the table below.

With respect to the investment environment, the Plan further provides for the Government to “identify the essential elements of the business and investment environment needed to encourage investment in general, in the Mozambican economy, and that need to be in place and maintained



in a transparent, stable and lasting way”.<sup>c</sup> It finds that, since “the development of the gas resources will require huge investments, throughout periods that will stretch for decades, it is vital that this environment is sustained and ameliorated as necessary”.<sup>d</sup>

### **Principles of the Natural Gas Master Plan**

**Regulatory clarity.** Clear definition of the responsibilities of regulators. This will have a positive impact on investment decisions, especially in downstream natural gas projects.

**Sustainable use of revenues.** The gas revenues constitute a clear form of directing the gas use to the economy for the creation of added value for the industry, and expansion of economic development. On the other hand, there would be sufficient revenue for supporting infrastructure and economic development in a number of areas in addition to the natural gas sector.

**Identification of needs and coordination of infrastructure.** It is necessary to define how the necessary infrastructure for the development—ports, roads, airports—needs to be created based on the gas production and use to meet the needs of communities that will host these gas-oriented enterprises. In addition to the infrastructure for natural gas, there is also a need for coordination with the planning of electricity and the development of other infrastructure.

**Education and training.** The limited professional training and capacity building are a major obstacle to the employment of Mozambican workforce in the gas sector. Continuous efforts of technical training and education in general must be developed in the specialties that the industry will need.

**Regional development.** The gas discoveries made by Anadarko and ENI, in the Rovuma Basin, are located in Palma, in the far northeast region of Cabo Delgado. The largest employment figures would come from development centres near these major cities. However, Cabo Delgado is in urgent need of programmes to stimulate development, as it is also one of the least developed areas of the country.

**Promotion and inclusion of small and medium-sized enterprises (SMEs).** Natural gas is an attractive fuel for SMEs, for its uses in heat production and raw materials. It can also stimulate the production process that allows them to be internationally competitive. Appropriate mechanisms to encourage the use of gas for the development of SMEs should be adopted.

**Environmental sustainability.** Lessons learned from some countries show that there can be no development if the exploitation of resources

damages the environment and traditional livelihoods in an unacceptable manner. The Government's approach to the development of the gas market has been, and will be, implementing a policy of sustainability and environmental protection. This is doubly important where offshore projects are implemented, and may affect fisheries and tourism.

**Use of local resources.** The use of local resources such as raw materials, national labor force and domestic enterprise services, should be prioritized in order to raise people's living standards, and make national companies profitable and create internal capacity to operate, generate employment among nationals and ensure maintenance of the machinery and equipment used in the national Natural Gas operations.

- a Republic of Mozambique, Cabinet Council, Natural Gas Master Plan, 2014. Available at <http://www.inp.gov.mz/en/Policies-Legal-Framework/Policies/NATURAL-GAS-MASTER-PLAN2>
- b Ibid, p. 23.
- c Ibid, p. 28.
- d Ibid, p. 28

| <i>Pillars</i>                            | <i>Strategic objectives</i>                                                                                                  |
|-------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|
| <i>Economic and institutional aspects</i> | Ensure the availability of gas for the domestic market, facilitating the industrialization of the country.                   |
|                                           | Develop and implement a communication plan to increase transparency and manage expectations.                                 |
|                                           | Maximize national support for the development of natural gas projects.                                                       |
|                                           | Encourage and support the use of natural gas in domestic industries.                                                         |
|                                           | Increase institutional expertise in matters related to gas, including exploration, development and marketing of natural gas. |
| <i>Financing and tax aspects</i>          | Establish and maintain a good business environment.                                                                          |
|                                           | Establish a financing mechanism for the development of gas projects and for local development initiatives.                   |
|                                           | Improve the existing legal framework regarding natural gas.                                                                  |

|                                           |                                                                                                                                                  |
|-------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|
|                                           | Ensure the Government's share of gas, both in kind and in cash.                                                                                  |
| <i>Environment and social development</i> | Ensure that the local communities, in particular in the areas of exploration and production, are benefiting from natural gas-related activities. |
|                                           | Create and/or increase the environmental awareness of local communities.                                                                         |
|                                           | Prevent and/or mitigate environmental damage resulting from the production and use of natural gas.                                               |
|                                           | Strengthen institutional capacity for the implementation of environmental legislation.                                                           |
|                                           | Training and capacity building of the national workforce.                                                                                        |

## Box I.2:

**Investment principles and goals: investor perspective**

Investor principles for developing country natural resources investment policies.<sup>a</sup>

**The overall fiscal and regulatory structure should begin with an alignment on valuing and recovering resources in a manner consistent with the country's framework for economic development, and should**

- Create the greatest overall value from the country's resources
  - Provide revenues for country (including all governmental stakeholders) to reinvest;
  - Promote growth in local economies as part of value creation via development of local infrastructure, industries, jobs and training;
  - Generate value through maximum life cycle economic recovery of resources consistent with the most efficient, safe and environmentally sound development and decommissioning and restoration.
- Be equitable to both government and investors
  - Ensure the government, as ultimate steward of the resources, receives for the country an equitable share of the benefit from its resources;

- Provide that investors receive a share reflecting all of their contributions and commensurate with the overall risks they bear.
- Align government and investing companies' interests throughout project life
  - The regime should be responsive such that equitable sharing of value is realized through all stages of the project life cycle and across ranges of outcomes and market conditions;
  - Recognize that projects and relationships are long-term and seek ways to promote partnership and mutual trust.
- Promote a stable and sustainable business environment
  - Country and investors should be able to plan ahead and rely on agreed terms;
  - Investors should be willing to manage and accept business risks (e.g., exploration, technical, project execution and operation, and market conditions (price and costs) and country should seek to provide maximum possible certainty on rights and economic terms (e.g., rule of law, contract terms, legal framework, and fiscal terms);
  - Investors and country should operate in good faith to resolve and satisfy potential disputes quickly and efficiently; adoption of mutually agreed dispute resolution procedures, such as mediation and/or arbitration practices, may promote this goal.
- Be administratively simple
  - Provide a clear, practical, enforceable, stable, and non-discriminatory framework for administration of laws, regulations, and agreements;
  - Adopt programmes promoting cooperation and trust between tax administrators and taxpayer.
- Be competitive
  - Should attract widest range of potential investors to ensure country maximizes competition for its resources;
  - Should strive to be competitive with other countries given relative attractiveness and risks of resource development.
- a** This illustration is, with modifications to broaden coverage to all extractives, based largely on a set of investment principles published in the EI SourceBook and developed by the International Tax and Investment Center. Available at [http://www.eisourcebook.org/2889\\_OilGasSpecifics.html](http://www.eisourcebook.org/2889_OilGasSpecifics.html).

## Industry overview

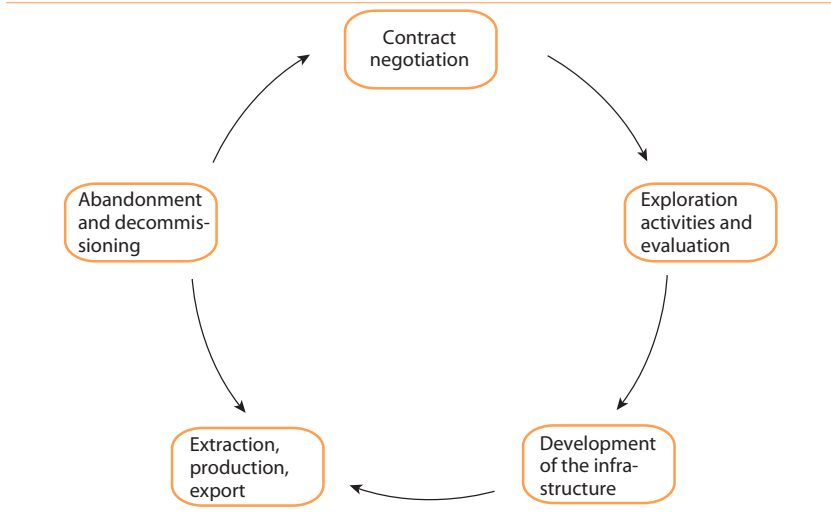
As noted, there are similarities but also many differences between the extractive industries and other industries that should be taken into account when designing and administering a tax regime. In order to better understand the specific problems that may arise in the extractive industries, a diagram of the generalized life cycle of a natural resource project is shown below in figure I, followed by an overview of the oil and gas and hard minerals industry structures.

### *Extractive industries structures: life cycle*

The life cycle of an extractive industry project has five broad phases, as illustrated below:

Figure I.1:

#### **Life cycle of an extractive industry project**



### *Extractive industries structures: oil and natural gas*

The oil and gas industry involves exploration and production, transportation and the refining of crude oil and natural gas, and manufacturing, distribution and marketing of crude oil and petrochemical products and liquefied petroleum gases.

In the oil and gas industry, reserve ownership and production are dominated by governments and government-owned or sponsored national companies, the latter increasingly investing outside of their residence countries and becoming major competitors of publicly traded multinational companies. Government-owned national oil companies (NOCs) control 78 per cent of global oil reserves and 58 per cent of global oil production.<sup>10</sup> In addition to NOCs, international oil companies (IOCs)<sup>11</sup> also supply oil to the market, such that 84 per cent of the world's oil is produced by about 100 companies (NOCs or IOCs).

NOCs can encompass various degrees of government involvement, and often operate as government agencies or corporate entities. NOCs operating as an extension of the government mainly aim for macroeconomic goals such as employing residents, furthering a government's domestic or foreign policies, generating long-term revenue to pay for government programmes, and supplying inexpensive domestic energy. In contrast, NOCs with strategic and operational autonomy<sup>12</sup> balance profit-oriented concerns with the well-being of the country as a whole.<sup>13</sup>

IOCs are investor-owned, market-oriented, and mainly aim to increase shareholder value. Various degrees of size, specialization and integration exist in IOCs. Often, companies specialize in one or more individual industry segments, such as the exploration and production, refining, transportation/distribution or marketing segments.<sup>14</sup> Many

---

<sup>10</sup> NOCs are, for example, Saudi Aramco (Saudi Arabia), Pemex (Mexico), the China National Petroleum Corporation (CNPC), the Nigerian National Petroleum Corporation (NNPC), and Petr6leos de Venezuela, S.A. (PdVSA).

<sup>11</sup> IOCs are integrated companies such as ExxonMobil, BP p.l.c., Royal Dutch Shell or Repsol, and many companies focused purely on exploration and production, such as ConocoPhillips, Apache, Tullow and Ophir Energy.

<sup>12</sup> NOCs with strategic and operational autonomy are, for example, Petrobras (Brazil) and Statoil (Norway).

<sup>13</sup> See U.S. Energy Information Administration, *Oil: Crude Oil and Petroleum Products Explained — Where our oil comes from*. Available at [http://www.eia.gov/energy\\_in\\_brief/article/world\\_oil\\_market.cfm](http://www.eia.gov/energy_in_brief/article/world_oil_market.cfm).

<sup>14</sup> There are independent refining, marketing, pipeline, shipping, and exploration and production companies, as well as major service companies

of the largest multinational oil and gas companies integrate all businesses, and are referred to as “vertically integrated” oil companies.

The oil and gas industry is often considered to have two major parts: the upstream activities—those related to the exploration and production of crude oil and natural gas, and the downstream activities—those related to the transportation, refining and marketing of oil and natural gas and their products.

### *Upstream*

The exploration and production activities are the beginning stages of the life cycle and involve large upfront capital investment that carries significant risks in terms of achieving commercially successful results. Lead times from exploration through development to first production are long—often 10 years or more—further increasing project risks.

Investors often seek to reduce risks via project diversification, often in cooperation with other partners. The oil and gas industry is characterized by joint ventures (JVs) involving an operator along with several other investing partners that own undivided interests in the project and participate in decisions pursuant to an operating agreement. This approach is (and has traditionally been) the most common way of sharing economic risks. JV partners can also include government bodies or NOCs.

The first phase of upstream activities (i.e. the acquisition of exploration rights) can occur via several methods, including participation in companies; entering into a joint venture with other investors to find or to develop resources; international bids (unilaterally or with partners); direct negotiations with governments and/or nationally owned oil companies; and outright purchases of assets or companies.

An exploration contract or licence can last for several years, divided into subperiods during which the company commits to a series of investments in geological, geophysical and seismic work and to drill a certain number of exploratory wells.

---

(also referred to as subcontractors) providing seismic, drilling, construction, environment and environmental and other services and technologies for all phases of the international oil and gas industry.

The operation, management, and policymaking procedures of a JV are regulated in a “joint venture” or partnership agreement called a Joint Operating Agreement (JOA). In the JOA, one of the participating companies is designated as the “operator”, responsible for the day-to-day management of the activities to be performed, and the implementation of the decisions taken by the partners, including representation vis-a-vis local governments and third-party providers of services and materials.

Photo I.1:

**Upstream offshore production facility**



Source: Currahee/ 123RF.com

The operator assigns its own resources to the project (i.e., a team of technical and administrative support) that are charged at cost to the joint venture and allocated to each party based on its ownership percentage.

Non-operator companies are responsible for controlling and overseeing that the activities performed by the operator are carried out according to quality standards and that the costs are in conformity with the agreement and budget of the consortium.

In the case of a commercial discovery, following government approval, the development phase commences, consisting of investments in engineering, development drilling, construction of processing facilities, civil works, platforms, well production and control facilities, and oil and gas transportation/offloading systems.



The operator forms a development team to conduct the development project, which involves coordinating with the partners as well as with the numerous subcontractors and service companies involved, and to ensure compliance with, and sound administration of, the contracts involved.

The development phase can last from a few months to three years or longer depending on the size, location and complexity of the site to be developed.

Once the facilities and offloading systems are commissioned and development surveys are completed, the production phase starts. Contractually, this phase usually lasts between 15 and 25 years, provided that the economic limit of the field has not been reached earlier. Throughout time, new and/or improved assisted recovery techniques are applied to maximize production levels and reserve recovery.

Throughout the project, the environmental impacts need to be assessed and managed to minimize adverse impacts and, at the end of the project's life, contracts generally provide for the decommissioning of the structures, and restoration of the site.

### ***Downstream***

“Downstream” is the term generally given to the transportation of crude oil and natural gas and to the refining, storage, distribution and marketing of crude oil and its derived products. Refining involves conversion of crude oil into industrial and consumer products such as petrol, diesel, liquid petroleum gas, aviation fuel, bunker for marine transport, and chemical feedstock. Marketing can involve retail petrol station activities and other marketing to wholesale or retail customers, including petrochemical manufacturing activities.

Activities connecting the pure upstream and downstream functions are sometimes referred to as “midstream,” and consist of trading and transportation (by pipeline, rail, barge, tanker or truck) storage, and wholesale marketing of crude oil, natural gas or refined petroleum products. These functions can be performed within integrated companies (where they are also called the Supply and Transportation (S&T) function) or by independent businesses specializing in one or more of these activities.

Photo I.2:

**Downstream refining complex**



Source: photowrzesien/ 123RF.com

An integrated company's S&T function is important since companies often lack sufficient production of their own, in total or in the right locations or specifications, to meet their refining or marketing needs. These constraints are addressed by businesses actively involved in purchasing, exchanging, and/or selling of crude oil, intermediate or end products. Additionally, the fact that many producing and refining countries export their production to other markets requires a robust supply and transportation industry.

***Liquefied natural gas: an expanding business***<sup>15</sup>

The liquefied natural gas (LNG) business involves upstream, midstream, and downstream elements in the commercialization of natural gas

---

<sup>15</sup> See United States Department of Energy, *Liquefied Natural Gas: Understanding the Basic Facts* (Washington, D.C.: 2005), available at [http://energy.gov/sites/prod/files/2013/04/f0/LNG\\_primerupd.pdf](http://energy.gov/sites/prod/files/2013/04/f0/LNG_primerupd.pdf) (August 2005); see also *B.C. and Petronas reach LNG agreement paving way for energy giant's proposed \$36-billion investment*, Financial Post (May 2015), available at <http://business.financialpost.com/commodities/energy/malysias-petronas-and-b-c-reach-lng-deal-paving-way-for-companys-proposed-35b-investment/wcm/368d8783-0dc6-4d95-ba93-019db3191e9e>.

resources through extracting and processing, liquefying, transporting such liquefied gas in special ships, re-gasifying it in processing facilities, and delivering it to customers. LNG projects involve very large upfront capital investments, with a development phase typically between five and six years. Given the significant upfront capital investment, LNG suppliers typically require revenue certainty by having off-take contracts for a significant portion of the expected LNG production to be in place prior to a final investment decision. Once LNG projects are in the production phase, they can continue producing for 30–50+ years depending on the size of the gas resource and the investment of additional capital expenditure during the project life.

Photo I.3:  
**LNG tanker**



Source: photowrzesien/ 123RF.com

### ***Extractive industry structures: mining***

The mining industry worldwide is often described as having a formal and an informal sector. The formal sector has been estimated to include approximately 6,000 public and state-owned companies. Within this group, the 20 largest companies accounted for some 30 per cent of global output in 2010, and the largest 150, sometimes referred to as the

“majors,” accounted for approximately 85 per cent of global output.<sup>16</sup>

Photo I.4:

**Large-scale mining project**



Source: dennisdvwater/ 123RF.com

The majors are often broken into two categories: global (the largest 50 companies, with asset bases in excess of \$10 billion) and senior companies (the next largest 100 companies with asset bases generally in the \$3 billion-10 billion range) followed by approximately 350 “intermediates” with lower access to capital but with goals of growing into the major category. Below the intermediates are three categories of so-called junior companies: those large enough to be involved in exploration and production, those only involved in the exploration phase, and, finally, the smallest involving companies that are at the threshold of the formal industry sector and are seeking venture capital to grow within the industry.

The informal sector of the industry includes 15 to 20 million firms operating in 30 countries and employing 80 to 100 million people. This compares to the approximately 2.5 million people employed by the

---

<sup>16</sup>See Magnus Ericsson, *Mining industry corporate actors analysis*, POLINARES Working Paper No. 16. Available at <http://www.eisourcebook.org/cms/Mining%20industry%20corporate%20actors%20analysis.pdf>.

formal sector, half of whom are employed by the majors. The formal mining sector operates under legal and fiscal frameworks, but application of such rules and standards in some parts of the informal sector of the industry can be challenging.<sup>17</sup> For some minerals, artisanal and small-scale miners can account for a substantial amount of the value of minerals extracted (e.g., less than 5 per cent of worldwide iron, lead, zinc and copper but 25 per cent or more of gold, tin and tantalum).

Photo I.5:

### Small-scale mining



Source: sergioz/ 123RF.com

The mining industry life cycle is delineated into four stages: prospecting/exploration, development, production (including processing), and closure/reclamation. The period between the production and permanent closure stages may involve a suspension of production where the mine is placed under “care and maintenance”. This may become necessary for a number of reasons, including prevailing economic conditions or unfavourable resource prices, and may continue until fundamentals improve or the operations are otherwise turned around.

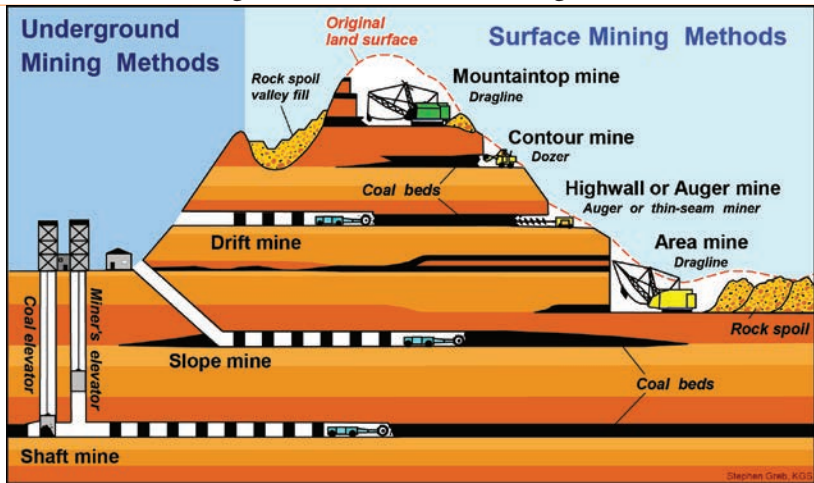
---

<sup>17</sup> The informal sector of the industry is made up of small-scale and very small-scale (sometimes described as “artisanal”) miners. See International Council on Mining and Metals, *Trends in the mining and metals industry, Mining’s Contribution to Sustainable Development* (October 2012). Available at <http://www.ibram.org.br/sites/1300/1382/00002639.pdf>.



The mining industry typically does not have the level of unincorporated joint ventures that oil and gas does; it is more common for one investor to be involved in any particular project. There is less direct government participation in mining projects as compared with the oil and gas sector, and the mining sector does not have national mining companies comparable to NOCs. But like the oil and gas industry, the use of subcontractors is prevalent throughout many phases of the life cycle of a mine.

Figure I.2:  
Schematic of underground and surface mining methods



Source: Kentucky Geologic Survey, reprinted with permission. Available from <http://www.uky.edu/KGS/coal/coal-mining.php>

### *Prospecting/exploration*

The exploration phase, often consisting of reconnaissance and prospecting activities, generally involves the greatest uncertainty. The inherent risks of the exploration stage are similar to those described for the oil and gas industry. Exploration and prospecting activities are undertaken to identify whether mineral deposits exist. Subsequently further work is undertaken to define the mineral deposits (the ore body)—that is, its extent and location as well as its peculiarities. Following this, a feasibility study is undertaken to determine the commercial and financial viability of the project. Risks and potential upsides are also taken into account at this stage. Significant risks of

commercial viability are inherent to exploration as the feasibility and other studies could conclude that a project is not commercially viable based on external market variables as well the mining company's own internal trigger points. The time frames from exploration through development to first production can range from three to 10 years.

### ***Development***

Once exploration activities have demonstrated that there is a viable mining opportunity, the development phase commences. During the development, detailed geological and geothermal studies are undertaken to map the ore body and to substantiate the economics of the mine. This enables detailed mine planning. The required infrastructure and mine processes are developed at this stage. During the development stage, significant capital investments are made in expectation of eventual income when the mineral is extracted.

In addition to the above and in recognition of the socioeconomic and environmental implications of mining, regular studies should be undertaken to determine and properly plan for minimizing the impact of mining on the environment as well as surrounding communities.

### ***Production***

Physical production of the ore, which can be called the "mine/mill" phase of mineral development, makes up the bulk of the mining life cycle. At this stage, due to the detailed development work that has been done, the overall life of the mine, based on current economic and market fundamentals can be determined. The ore that is mined is generally physically prepared (via crushing, grading, and grinding) and concentrated for further processing so as to extract the raw mineral.

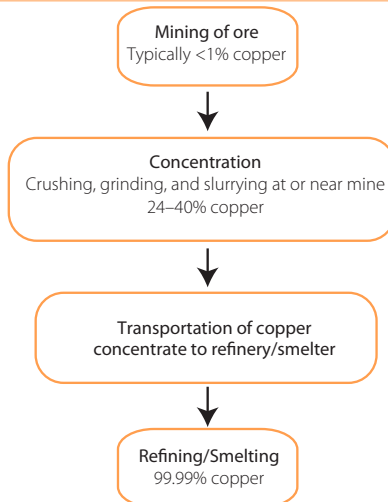
Waste and tailings resulting from the processing activities need to be carefully managed at this stage so as to prevent adverse environmental effects.

The ore or unrefined mineral product may then be further processed near the mine/mill facility, but is more often transported to an offsite processing facility. Processing can take the form of smelting, leaching or refining, which are value-adding processes that result in the final products being available for sale in the open market.

Prospecting/exploration, development, and production are similar to oil and gas upstream activities, and the further processing and transportation are similar to the oil and gas downstream. The terms “upstream” and “downstream” are, however, not as commonly used to describe mining activities as they are for oil and gas.

Similar to the oil and gas industry, sale and transportation of ore, unrefined metals, and ultimately the upgraded and refined metals and metal products globally is an increasingly important aspect of the industry. Many mineral-producing countries export ore or upgraded products to markets around the world. Further, mechanisms to reduce or manage risks—including commodity price risks—are necessary realities of a business undertaking the inherent risks of worldwide mining. Thus, as within the oil and gas business, these logistics and risk management issues need to be addressed by active businesses or functions designed to meet business objectives and optimize processes and costs.

Figure I.3:  
Schematic of physical mine processing activities<sup>18</sup>



Source: <http://investingnews.com/daily/resource-investing/base-metals-investing/copper-investing/copper-refining-from-ore-to-market/>

<sup>18</sup>Note that concentrate containing other elements may be yield credits (for desired ones such as gold or silver) or financial penalties (for undesired ones such as lead).



## Overview of fiscal instruments and their characteristics

Minerals and oil and gas agreements or contracts often have some unique features and at times are subject to specific legal, tax, and commercial requirements. They often are limited to certain geographical areas and may involve a completely different legal, tax and economic regime from general business activities, and even from natural resource contracts covering a different area. Requirements often include separate and independent accounting for each mine or contract area.

Fiscal systems governing natural resources generally fit into two broad categories: concession or contract regimes.<sup>19</sup>

### *Concession regimes*

Concession regimes are often also described as “tax and royalty” regimes. These are common both to the mining and petroleum industries and are usually prescribed by law.<sup>20</sup> Minerals or oil and gas extracted pursuant to these arrangements belong to the investors, who in exchange for such rights generally pay a royalty on the volumes extracted as well as other payments such as bonuses and delay rentals. In addition, some sort of profit-based taxation is usually due on the profits related to the venture or the exploiting company. Concession regimes may also involve equity participation.

Application of a regular corporate profit tax ensures income is taxed at the corporate level just as in other sectors. However, many countries apply a higher tax rate on mining and petroleum activities, while others have separate income tax regimes addressing

---

<sup>19</sup> For further information about fiscal instruments in the extractives sector, see IMF, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012), available at <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>; IMF, *Guide on Resource Revenue Transparency* (2007), available at <http://www.imf.org/external/np/pp/2007/eng/051507g.pdf>; Philip Daniel, Michael Keen and Charles McPherson (Eds.) *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (New York, Routledge, 2010) particularly, chapter 4, Carole Nakhle, “Petroleum fiscal regimes: evolution and challenges”, p. 89 and chapter 5, Lindsay Hogan and Brenton Goldsworthy, “International Mineral Taxation: experience and issues,” p. 122.

<sup>20</sup> For example, in South Africa, permits are issued and rights are granted under national legislation.

sector-specific issues. In contrast to royalties and bonuses, profit taxes are only levied on a profitable investment.

Some of the most important profit-based taxes used are company income taxes, excess profits (or variable income) taxes, and resource rent taxes. Since such taxes are profit based, in early years of projects, or in low-price environments, they will yield less revenue than some non-profit-based taxes. In high-priced environments, the opposite is generally true.

Royalties are generally calculated as a percentage of the gross volume or value of the production (i.e., costs do not reduce the base) and are due once production commences (versus profit-based taxes which are often delayed as production ramps up and cost recovery reduces net profits). They are relatively predictable and ensure some payments in times of low prices and revenues. As the payment of royalties does not require the project to be profitable and are not reduced by production costs, governments seeking revenues early in the project life might choose to impose royalties as one part of their overall fiscal structure.

Bonuses can be attractive to governments since they provide early revenue and are easy to administer. Since bonus payments are usually made upfront before knowledge of commerciality, and are unrelated to production, they are generally less attractive to investors. Bonus costs can be recovered, if at all, only from profits.

### ***Contract regimes***

Contract regimes generally embody two categories: production sharing contracts and risk service contracts.

#### ***Production sharing contracts***

Production sharing contracts (PSCs) are common within the oil and gas industry, but less so in the area of hard minerals. Under such contracts, states share the results of the exploitation with the investors.

PSCs generally provide a formula for sharing the production between the investor and the government (or government-owned company). As with the concession arrangements, ownership of the investors' share of such production generally vests with the investors upon production.

Normally, but not always, a royalty on gross production is payable, with a certain percentage of the remaining production (usually called “cost oil”) allocated to the investor to cover its actual investment and production costs. Recoverable costs exceeding the cost oil allocation for a particular year are generally carried forward. After deducting any royalty amounts and cost oil entitlement, the remaining amount (called “profit oil”) is allocated per percentages or formulas in the agreement between the investors (as a return on investment) and the government. Profit oil is generally also subject to the profit-based taxes imposed, which can be variable. Thus, the government obtains its share of profit oil outright, along with a payment or a larger in-kind allocation of the investors’ profit oil to cover the investors’ income taxes. The profit oil allocation percentage between the investors and the government can also change over time based on overall profitability of the project. Costs recoverable under the cost oil definitions may be different in amount and in timing from those that are deductible under income or profit-based tax rules.

### ***Risk service contracts***

Risk service contracts are found primarily in the oil and gas sector. Under a service contract, the State owns the oil and gas that can be exploited and pays a fee to the investors for the exploration and production services. All production is effectively owned by the State, in contrast to concession regimes and PSCs.

Risk service contracts can take several forms, but they generally place full investment risk on the contractor/investor in return for a fee (which may be paid in the form the oil or gas produced). The fee can be subject to profit-based taxes.

### **Other fiscal terms**

#### ***Equity participation***

Governments may also desire an equity stake in a project, as a means of increasing government revenues over time or for non-fiscal motivations such as a desire for direct government ownership, the possibility to participate in decision-making, or a means to promote knowledge transfer. State equity can take different forms. Fully paid-up equity on

commercial terms puts the government on the same footing as the private investor. Where governments do not have, or do not wish to risk, the funds needed to bear the costs on an ongoing basis as a full equity partner, they may request their cost shares to be advanced by the other investors. Under a carried interest arrangement, the government's equity share of exploration and/or development costs are advanced by the other investors, with a recovery of such "carried costs" to come from production. Where a government owns an equity share of the project, its interests with respect to that share are well aligned with the other investors; this can promote ongoing cooperation and collaboration.

Table I.1:

**Types of petroleum rights and contracts**

| Type of contract                                                      | Cost and risk   | Exclusive right to operate | Right to production |
|-----------------------------------------------------------------------|-----------------|----------------------------|---------------------|
| Licence/concession {or Concession (tax and royalty) Contracts}        | Private company | Private company            | Private company     |
| Joint venture {or Participation/Association (or Arrangements)}        | Private company | Shared                     | Shared              |
| Production sharing {or Product Sharing Contract/ Agreement (PSC/PSA)} | Private company | State                      | Shared              |
| Service contract                                                      | Private company | State                      | State               |

***Other taxes and fees***

A number of other taxes and fees can also be imposed on the natural resources industries. Some of the more common ones are briefly noted below.

Broad-based consumption taxes in the form of value added, sales, or goods and services taxes are often levied by countries and are designed as taxes on domestic consumption. They are generally refundable on exports. Since much of the natural resource production in developing countries is exported, consumption taxes usually do not

provide lasting revenues to governments. In the exploration and development stages for the extractives industry, consumption-based taxes can, contrary to their design, represent a cost to the industry. This is because during the exploration and development phases, significant capital expenditure is incurred but no exports or revenues exist. Thus, companies are often faced with negative cash flow impacts from consumption taxes unless refunds are processed in a timely manner. Consumption taxes can put additional strain on tax administrations, as they require significant administrative efforts.

In general, sales or other disposition of business assets are frequently subject to income taxation on the net gain from such transfers under a country's tax on ordinary income or in the form of a capital gains tax. The scope of transactions covered by such taxes varies widely.

Dividend or other profit distributions, interest, royalties and subcontractor payments to non-residents are common and can be significant. Withholding taxes on these payments, which allow source States to effectively tax this income, are often borne by investors and are another component of the overall fiscal take. Withholding tax rates on payments to subcontractors are typically set at relatively low levels, reflecting the fact that they are levied on a gross basis. In many circumstances, regional, multilateral or bilateral income tax, trade, and investment treaties may reduce withholding tax rates and may also take precedence over other general provisions of tax laws, dispute resolution procedures, or other statutory provisions.

Numerous other fees and taxes can become part of an overall fiscal package, including items such as customs duties, excise taxes, pipeline fees, export fees, property taxes, and personal income taxes. Source countries should be conscious of the overall fiscal package applicable to investors. The optimal design of any tax system governing the extractive industries, including the application of bilateral tax or investment treaties, will often be a blend of the fiscal instruments described above. As mentioned, fiscal policy will need to be designed to further a country's development plan, which is tasked with balancing various needs.

Tax provisions applicable to the natural resource sector may be the same as for all other industries and encompassed in a more general tax law. In other cases, there may be a desire for special tax legislation

applicable just to the natural resource sector. A third option is to tax extractive industries according to the corporate income tax laws, but with additional provisions applicable specifically to their industry. Application of tax, trade or investment treaties may also be general or industry specific. The most effective overall design should provide a country with adequate resources and ensure administrative ease while being responsive to the needs of investors.

### **Transparency in the extractive industries**

The extractive industries are the subject of a number of transparency initiatives, and the extractives sector is often in the forefront of a growing movement for greater transparency for all businesses.<sup>21</sup> For example, the Extractive Industries Transparency Initiative (EITI) which grew out of the Extractive Industries Transparency Initiative London Conference, held in June 2003, began by requiring (i) all investors doing business in the country to report all payments made to governments or their agencies; (ii) governments to publicly report on the payments as having been received; and (iii) an independent audit and reconciliation to be done. On its website, the EITI describes how

(...) it has evolved from its beginnings as a narrow set of rules focused on revenue collection into an international standard covering the wider governance of extractive resources. It now encompasses beneficial ownership disclosure, contract transparency, the integration of the EITI into government systems and transparency in commodity trading. The focus of EITI

---

<sup>21</sup> In addition to EITI, a number of other important transparency initiatives exist that are specific to the extractive industries, including certain requirements under the Dodd-Frank provisions of US law, the European Union Accounting Directive, plus UK and Norwegian government payments rules, and the Extractives Sector Transparency Measurement Act (ESTM) in Canada. In addition, a major project within the IMF to update its general fiscal transparency code and to formalize the update as a new Natural Resources Fiscal Transparency Code is in its final stages. See <http://www.imf.org/external/np/exr/consult/2016/ftc/>. See also, *Transparency Mechanisms and Movements: Tools to Foster Openness and Accountability*, Natural Resources Governance Institute (2015). Available at [http://www.resourcegovernance.org/sites/default/files/documents/nrgi\\_primer\\_transparency-mechanisms.pdf](http://www.resourcegovernance.org/sites/default/files/documents/nrgi_primer_transparency-mechanisms.pdf).

Reports has moved from compiling data to building systems for open data and making recommendations for reforms to improve the extractive sector governance more generally.<sup>22</sup>

Public access to extractive industries contracts between investors and countries is a growing element in promoting overall transparency. In some cases, governments are now requiring such publication, and in most cases more general transparency initiatives (like the EITI) either recommend or require extractive industries finalized contracts to be made publicly available.<sup>23</sup>

A properly designed and cost-effective reporting mechanism can help to create a climate of trust between investors and governments, and with the public, with respect to natural resource development.

Investments in natural resources in developing countries can play an important role in providing governments with the resources needed to reduce poverty while meeting the world's energy and economic needs. However, natural resource development must be done safely, efficiently, and in an environmentally sound way. Investors, working together with developing country governments and local communities, must earn trust and support. Likewise, governments must gain the trust and support of investors. And both governments and investors, given the high impact (both physically and financially) of natural resource development, must also gain the trust and support of the public at large. Transparency in reporting is a key element contributing to the development of trust.

## **Issues for developing countries; the role of the United Nations Tax Committee**

As evident from this Overview, designing appropriate tax regimes in resource-rich countries is far from easy. Developing countries are

---

<sup>22</sup> See <https://eiti.org/history>.

<sup>23</sup> In addition to EITI (<https://eiti.org/>) other sources include the EI Source-Book available at <http://www.eisourcebook.org>, Open Oil, available at [openoil.net](http://openoil.net) and Resource Contracts, available at <http://www.resourcecontracts.org/>. Sample mining agreements and models/examples of mining contract provisions are available under the Model Mining Development Agreement Project, available at <http://www.mmdaproject.org/>.

faced with additional difficulties given the often-prevalent lack of resources in tax administrations. As mentioned above, the need for revenue should be balanced with the need to attract foreign investment. At the same time, governments have to ensure that investments adequately contribute to economic growth and employment creation, while adhering to social and environmental standards.<sup>24</sup>

The United Nations Tax Committee has approved work in the area of taxation of extractives on several areas considered the most pressing for developing countries. In addition to this Overview, issue-specific chapters cover, in order:

## **Chapter 2: Tax treaty issues**

Bilateral tax treaties play an important role in coordinating tax rules for cross-border activities and eliminating obstacles to cross-border trade and investment. Extractive activities usually include numerous cross-border elements. They are undertaken by investors, licence holders, service providers and suppliers who are often not resident in the source country. Natural resources produced are typically exported. These elements raise several tax treaty issues for the extractive industries that are discussed in this chapter.

In particular, the chapter includes commentary on which taxes are covered by a treaty, when activities of investors, contractors and subcontractors are taxable, how tax jurisdiction may vary throughout the life cycle of a natural resource project, how the term “royalties” as used in tax treaties differs from mineral/oil and gas royalties, whether a tax or other levy is creditable in the resident state of the investor, aspects of non-discrimination, and the territorial scope of the treaties.

The chapter also introduces the concept of permanent establishment (PE) and issues that arise in its application, considering the perspectives embodied in the United Nations Model Convention and its Commentary, as well as references to the Organization for Economic

---

<sup>24</sup> See Africa Progress Panel, *Equity in Extractives, Africa Progress Report* (2013), p. 63. Available at [https://static1.squarespace.com/static/5728c7b18259b5e0087689a6/t/57ab29519de4bb90f53f9fff/1470835029000/2013\\_African+Progress+Panel+APR\\_Equity\\_in\\_Extractives\\_25062013\\_ENG\\_HR.pdf](https://static1.squarespace.com/static/5728c7b18259b5e0087689a6/t/57ab29519de4bb90f53f9fff/1470835029000/2013_African+Progress+Panel+APR_Equity_in_Extractives_25062013_ENG_HR.pdf).



Cooperation and Development Model Convention and other specific bilateral treaties.

### **Chapter 3: Permanent establishment issues**

This chapter focuses on Article 5 of the United Nations Model Convention and how this article influences the taxation of the extractive industries. Whereas the permanent establishment issue is addressed more generally in Chapter 2 on tax treaty issues, this chapter elaborates in-depth on the significance and existence of PEs of the investor and its subcontractors as a result of different activities performed by the extractive industries in the source country.

In the extractive industries, costs often arise before a permanent establishment is set up or after a permanent establishment has ceased to exist. Preparatory costs can include planning or exploration costs. Subsequent costs can arise due to decommissioning or activities associated with other liabilities. In addition, issues with respect to companies that rent drilling rigs, perform their activities on-board such rigs, and activities that take place at different wells or contract areas are also covered.

### **Chapter 4: Indirect transfer of assets**

This chapter deals with the question of whether and how a capital gains tax could be implemented. Domestic legislation could tax gains on sales of capital assets as general ordinary income, as capital gains taxable under the corporate income tax law, or under a stand-alone capital gains tax law. In cases where there is a capital gains tax on sales occurring within a country, the question of how indirect sales should be taken into account. Instead of transferring an asset (e.g. a mine itself (direct transfer)), the owner of an entity holding the asset may transfer its interest in that entity (thus “indirectly” transferring the underlying asset).

In the case of a direct transfer of a mining or petroleum right, even by a non-resident, the source country can levy a tax under its domestic law on the gain from the sale of such property. The chapter reviews issues and considerations a country may face in taxing or, in some circumstances, not taxing such direct transfers. Next, the chapter considers indirect sales of mining or petroleum assets. For example,

in order to protect the tax base of the source country in those cases, an indirect transfer tax rule could be implemented to tax indirect sales. The chapter reviews issues involved in making, implementing, and administering such a decision. An indirect transfer tax rule may involve both domestic law and applicable tax treaty issues, and the interrelationship of these is outlined in depth.

### **Chapter 5: Transfer pricing issues**

This chapter considers and analyses several examples of transfer pricing issues that arise in the extractive industries. It focuses on issues relating to the major stages in the extractive industries value chain, and suggests methods and approaches that might be considered in addressing the particular issues identified. Thereafter, the chapter provides several case examples that apply to both mining and O&G followed by more specific examples focused first on mining, and then on oil and gas, reflecting that mining and petroleum, while similar, also have certain important differences.

The chapter provides background information and a useful summary and checklist for developing countries in addressing some of the issues that commonly arise in the extractive industries. It should be used in conjunction with the recently updated United Nations Practical Manual on Transfer Pricing for Developing Countries (2017).

### **Chapter 6: The tax treatment of decommissioning**

At the end of its life cycle, the decommissioning of an extractive facility in a way that avoids environmental damage and adverse effects on local populations must be addressed. A key element in achieving comprehensive closure/dismantling of extractive facilities is ensuring adequate financial resources are available on closure. Properly taking into account decommissioning at the outset of projects and when designing fiscal rules governing the extractive industries is particularly important in developing countries where, quite often, there may be a lack of general legal framework addressing these issues.

Further, the financial and budget consequences must be planned for in advance of and throughout natural resource projects. For example, where a government directly participates via an equity share in a project, or through involvement of its national oil company, it will

have to plan for funding the share of decommissioning costs associated with its participating interest. In addition, even without direct participation, project-related net income, and thus income taxes paid to the government, will be reduced by the costs incurred in performing the decommissioning work. Where decommissioning cost deductions are not permitted until their actual expenditure (generally at the end of the project) tax losses may be incurred. How these are treated for income tax purposes will have an impact on when decommissioning is conducted and can significantly affect government budgets and even the overall value obtained by a country from the development of its natural resources. Governments must carefully plan for this impact.

This chapter describes these issues and examines the tax treatment and considerations involved in dealing with them. Examples from countries that have specific rules on decommissioning are reviewed and options for decommissioning, and their implications, are presented for consideration by countries in formulating their national policies and legislation.

### **Chapter 7: The government's fiscal take**

This chapter describes the various forms of payments and other compensation that governments can receive from the development of natural resources, their timing and responsiveness to differing economic environments, implications of each together with their cumulative impact on investors, and the sensitivities associated with their interaction with other statutory tax rules.

### **Chapter 8: Tax aspects of negotiation and renegotiation of contracts**

How countries attract outside investment while balancing their economic, environmental, and social needs is a major challenge, requiring careful upfront planning and priority setting. In some countries, laws are independently enacted governing the framework for investments in resources, and investors must determine whether they will invest based upon those prescribed rules. In many developing countries, however, where resource development is beginning, no overall framework exists, and often a negotiated framework for development between an investor or investors and the government governs natural resource

development. This chapter reviews various issues that arise in connection with the negotiation of such contracts, and the options regarding their renegotiation as circumstances or the parties involved change.

## Chapter 9: Value added tax

The chapter on value added taxes (VATs) covers the key issues raised in applying VAT on the extractive industries, including policy and administration issues over the life cycle of natural resource projects. In particular, since many developing countries export most of their natural resource production, a VAT intended to tax domestic consumption should not provide a large source of lasting revenue, but timing and refund issues can be significant. The chapter covers these issues and addresses the effect a VAT may have as a barrier to direct investments. Implications on local content sourcing and other local economy spillover effects are described.

### For more information

- Africa Progress Panel, *Equity in Extractives*, Africa Progress Report (2013). Available at [https://static1.squarespace.com/static/5728c7b18259b5e0087689a6/t/57ab29519de4bb90f53f9fff/1470835029000/2013\\_African+Progress+Panel+APR\\_Equity\\_in\\_Extractives\\_25062013\\_ENG\\_HR.pdf](https://static1.squarespace.com/static/5728c7b18259b5e0087689a6/t/57ab29519de4bb90f53f9fff/1470835029000/2013_African+Progress+Panel+APR_Equity_in_Extractives_25062013_ENG_HR.pdf).
- L. Burns, *Income Taxation through the Life Cycle of an Extractive Industries Project*, Asia-Pacific Tax Fiscal Regimes for Extractive Industries Bulletin, vol. 20, no. 6 (18 November 2014), p. 401.
- Economic Commission for Africa and The African Union, *Minerals and Africa's Development: The International Study Group Report on Africa's Mineral Regimes*. Available at [http://www.africaminingvision.org/amv\\_resources/AMV/ISG%20Report\\_eng.pdf](http://www.africaminingvision.org/amv_resources/AMV/ISG%20Report_eng.pdf).
- EI SourceBook. Available at <http://www.eisourcebook.org/>.
- International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012). Available at <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>.
- International Monetary Fund, *Guide on Resource Revenue Transparency* (2007). Available at <http://www.imf.org/external/np/pp/2007/eng/051507g.pdf>.
- Philip Daniel, Michael Keen and Charles McPherson (Eds.), *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (Routledge:

New York, 2010). See particularly Chapter 4: Carole Nakhle, *Petroleum fiscal regimes: evolution and challenges*, p. 89, and Chapter 5, Lindsay Hogan and Brenton Goldsworthy, *International Mineral Taxation: experience and issues*, p. 122.

Silvana Tordo, *Fiscal Systems for Hydrocarbons: Design Issues*, World Bank Working Paper No. 123 (World Bank: Washington, D.C., 2007).

Extractives Industry Transparency Initiative, *2016 Progress Report*. Available at <https://eiti.org/eiti> and <https://eiti.org/files/progressreport.pdf>.



## Chapter 2

### TAX TREATY ISSUES

#### Executive summary

The extractive industries play an important role in the process of sourcing natural resources, which are critical for the development of many economies. Both developing and developed countries are actors in the process of natural resource extraction, both as host countries to the extractive activities and also as countries where the extractive industries companies have their head offices, raise capital and make strategic decisions. Extractive activities often include a cross-border element, due to global business models and integrated value chains. They are undertaken by investors, licence holders, service providers and suppliers who are often not resident in the source country. In this context, a number of international tax issues arise.

This chapter reviews tax treaty articles which are potentially relevant to economic activities of the extractive industries and highlights the issues that countries, especially developing countries, may wish to take into consideration in designing their tax treaty policy, negotiating (or re-negotiating) tax treaties and applying such tax treaties. Whereas this chapter deals with tax treaty issues especially from the perspective of the United Nations Model Convention, reference is also made to the Organisation for Economic Co-operation and Development Model Tax Convention (OECD Model Convention) where appropriate. In addition, some tax treaty provisions that depart from both the United Nations and the OECD Model Conventions and address specific problems related to the extractive industries are presented.

The issues raised in this chapter affect both the tax revenue of the jurisdictions involved and the tax position of companies involved in the extractive activities.

#### Background

Bilateral tax treaties play an important role in coordinating the rules of cross-border tax treatment and thus avoiding double taxation with the objective to eliminate obstacles to cross-border trade and investment.

This reduces the risk of excessive tax costs on cross-border investments. Tax treaties allocate taxing rights to one of the Contracting States, and limit the other Contracting State in exercising its domestic tax laws to the extent provided for in the treaty. The restriction may either be of an absolute nature — i.e., the tax treaty allocates an exclusive taxing right to the residence State or to the source State — or of a relative nature in that the tax treaty limits the source State to tax certain income only at a maximum applicable rate of tax and requires the residence State to either exempt the income or to grant a tax credit. Moreover, a tax treaty may also allocate non-exclusive unlimited taxing rights at source — for income from immovable property, for example. Tax treaties limit the taxing rights of both the source and the residence States and may thus limit the abilities of the source State to collect the tax revenue of income earned/sourced within the jurisdiction and of the residence State to tax its residents on their worldwide income.

It needs to be stressed that tax treaties always operate in conjunction with domestic law. Tax treaties play an important coordination role between the tax systems of two<sup>25</sup> Contracting States. The domestic law establishes and determines the issues relevant for the existence of the tax liability, while the tax treaty may suppress (fully or partially) or confirm this tax liability. The general view is that tax treaties do not create a tax liability.<sup>26</sup> Therefore, where the domestic law fails to establish a tax liability, the tax treaty will not remedy this situation.

Tax treaties also provide for measures to assure administrative cooperation. Article 25 of the United Nations Model Convention<sup>27</sup> provides for a mutual agreement procedure to eliminate double taxation in situations where the “competent authorities” of

---

<sup>25</sup>In rare instances, tax treaties may have a multilateral character (e.g., the Nordic Tax Treaty concluded between Denmark, Finland, Iceland, Norway, Sweden and the Faroe Islands).

<sup>26</sup>Some countries — Australia and France, for example — follow the practice that tax treaties may establish a tax liability.

<sup>27</sup>Unless otherwise noted, Articles referenced, due to publication deadlines, are those in the 2017 United Nations Model Double Taxation Convention between Developed and Developing Countries (2017). Available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf). The 2017 version of the Model is available at <http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html> and in most relevant respects is the same.



two Contracting States have different interpretations of the tax treaty. Article 25 of both the United Nations and OECD Model Conventions gives an important role to the competent authorities of the two states in avoiding or resolving disputes. If the taxation of one of the Contracting States is not in line with the tax treaty, the taxpayer may, under that article, initiate a mutual agreement procedure to resolve the situation. Article 26 contains rules regarding the exchange of information. Article 27 (when used) provides for assistance in the collection of taxes.

The United Nations and the OECD Model Conventions are used by many States as a basis for their tax treaty negotiations and therefore have considerable influence on international tax law. Currently, both the United Nations Model Convention (2017) and the OECD Model Convention (2017) contain only very few provisions specifically addressing issues arising in the extractive industries. The general rules contained in the tax treaty are also applied to specific issues and situations arising in the extractive industries. Due to the special nature of the extraction of natural resources, several countries have however included specific provisions regarding extractive industries in their tax treaties. One common example is a specific “Offshore Activities Article” in the Nordic Convention.<sup>28</sup> Some European States<sup>29</sup> have declared reservations to the OECD Model Convention and inserted such articles in their tax treaties.

Countries that neglect to pay special attention to the specific issues arising in the extractive industries when designing their domestic tax law and negotiating their tax treaties may potentially lose taxing rights in respect of income and capital raised by extractive activities taking place within their jurisdiction. They therefore may fail to obtain tax revenue which could otherwise be available for development activities. Furthermore, countries should be aware of possible situations where double taxation may arise along with the economic consequences thereof.

---

<sup>28</sup> See, for example, Article 21 of the Nordic Convention; Article 21 of the tax treaty between Denmark and Latvia (1993). A special Article for the exploration and extraction of hydrocarbons can be found in the treaties of Argentina, Australia, Denmark, Greece, Ireland, Latvia, Lithuania, Malta, the Netherlands, Norway, Sweden, the United Arab Emirates, the United Kingdom of Great Britain and Northern Ireland, and the United States of America.

<sup>29</sup> See reservations to the OECD Model of Denmark, Greece, Ireland, Latvia, Lithuania, Norway and the United Kingdom.

Box II.1:

**Example: Article 21 of the Denmark–Latvia Income and Capital Tax Treaty (1993)**

Activities in connection with preliminary surveys, exploration or extraction of hydrocarbons

Notwithstanding the provisions of Article 5 and Article 14, a person who is a resident of one of the Contracting States and carries on activities in connection with preliminary surveys, exploration or extraction of hydrocarbons situated in the other Contracting State shall be deemed to be carrying on in respect of those activities a business in that other Contracting State through a permanent establishment or fixed base situated therein.

Notwithstanding the provisions of paragraph 1, drilling rig activities carried on offshore shall constitute a permanent establishment only if the activities are carried on for a period or periods exceeding 365 days in aggregate in any 18-month period. However, for the purpose of this paragraph, activities carried on by an enterprise associated with another enterprise within the meaning of Article 9 shall be regarded as carried on by the enterprise to which it is associated if the activities in question are substantially the same as those carried on by the last-mentioned enterprise.

Notwithstanding the provisions of paragraph 1, profits derived by a resident of a Contracting State from the transportation by ship or aircraft of supplies or personnel to a location where offshore activities in connection with preliminary surveys, exploration or extraction of hydrocarbons are being carried on in the other Contracting State or from the operation of tugboats and similar vessels in connection with such activities, shall be taxable only in the first-mentioned State.

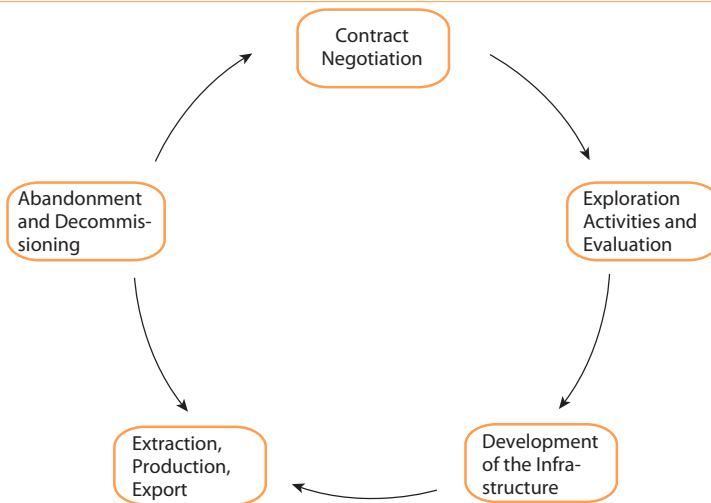
Salaries, wages and other similar remuneration derived by an individual who is a resident of a Contracting State in respect of labour or personal services rendered aboard a ship or aircraft covered by paragraph 3 shall be taxed in accordance with paragraph 3 of Article 15.

Notwithstanding the provisions of Article 13, a capital gain on drilling rigs used for activities mentioned in paragraph 2 which is deemed to be derived by a resident of a Contracting State when the rig activities cease to be subject to tax in the other Contracting State shall be exempt from tax in that other State. For the purpose of this paragraph, the term “capital gain” means the amount by which the market value at the moment of transfer exceeds the residual value at that moment, as increased by any depreciation taken.

## Overview of the extractive industries life cycle in relation to cross-border tax issues

Extractive industries activities often take place over a long period of time. The different critical activities can be divided into five main stages: (i) contract negotiation; (ii) exploration activities and evaluation; (iii) development of the infrastructure; (iv) extraction, production and export; and (v) abandonment and decommissioning. These stages could be further separated, for example the abandonment and decommissioning can be considered as two separate stages. Furthermore, the stages can overlap. While the exploration may be still ongoing, the development and even extraction can already take place at the same time. This life cycle is illustrated in the next figure.

Figure II.1:  
Life cycle of an extractive industry project



Source: UN/DESA.

Different international tax issues arise in each of these stages. The following table summarizes the key activities alongside the key domestic and international tax considerations.

Table II.1:  
Stages, activities, actors, domestic tax issues and potential international tax issues

| Stages                                | Key activities                                                                                                                                                            | Actors                                                                                                         | Domestic tax issues                                                                                                                                                                                                                           | International tax issues                                                                                                                                                 |
|---------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Contract negotiation and signature    | Extractive companies (investors) may engage in competitive bidding or contract negotiation with the assistance of advisers and lawyers                                    | Extractive company (operator or licence holder); consortium members; advisers, lawyers, financiers             | Obligatory (tax) payments, such as signature bonus; payments to advisers and withholding tax consideration                                                                                                                                    | Double tax treaty (DTT) coverage of signature bonus payments; taxation of income to advisers; applicability of a DTT                                                     |
| Exploration activities and evaluation | Exploration activities take place in various forms: geological studies, drilling and seismic tests, sampling and analyses; evaluation of potential for further extraction | Extractive company; subcontractors specializing in the exploration activities (onshore and offshore); analysts | Obligatory (tax) payments, such as discovery bonus; payments to subcontractors and the relevant tax considerations (including withholding tax); country's exercising of taxing rights over the territorial waters and exclusive economic zone | DTT coverage of discovery bonus payments; taxation of income to subcontractors; existence of permanent establishment (PE); tax treaty coverage of relevant offshore area |
| Development of the infrastructure     | Development of extractive facility (mining pits, extraction wells) and supportive infra-                                                                                  | Extractive company; subcontractors for construction, installation and drilling companies                       | Obligatory (tax) payments, such as development bonus (unusual); payments to                                                                                                                                                                   | DTT coverage of development bonus payments; subcontractor's PE (or absence of)                                                                                           |

Table II.1 (cont'd)

| Stages                            | Key activities                                                                                                                                                                                                                                                                                                                | Actors                                                                                       | Domestic tax issues                                                                                                                                                                                                                                                                                                                                           | International tax issues                                                                                                                                                                                                                                          |
|-----------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Extraction, production and export | <p>structure including transportation (roads, railway, pipelines) accommodation and office units as well as ancillary infrastructure; activities related to environmental and resettlement issues</p> <p>Extractive activities take place on a commercial scale; resources are processed and/or sold/transported/exported</p> | <p>Extraction company; subcontractors for processing, transportation, and other services</p> | <p>subcontractors and the relevant tax considerations (withholding tax)</p> <p>Extraction taxes (royalties, share from production sharing agreement, hydrocarbon taxes, corporate income tax, hydrocarbon tax); export-related taxes (excise, export customs duty, export rent taxes, and other); payments to subcontractors and the relevant tax consid-</p> | <p>DTT coverage of extraction-related taxes; subcontractor's PE (or absence of); treatment of administrative adjustments of prices for natural resources (transfer pricing); tax treaty implications of profit repatriation and payments to capital providers</p> |

Table II.1 (cont'd)

| Stages                          | Key activities                                                                                                                          | Actors                                                                                                   | Domestic tax issues                                                                                                                                                                                                                                                                                                                                                                                                                                           | International tax issues                                                                                                       |
|---------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------|
| Abandonment and decommissioning | Extractive activities are finalized and are replaced by decommissioning activities, clean-up of pollution and removal of infrastructure | Extraction company; subcontractors specializing in decommissioning and environmental clean-up activities | erations (withholding tax); adjustments to prices for natural resources (transfer pricing); tax implications of profit repatriation and payments to capital providers (rent and debt)<br><br>Special decommissioning/ rehabilitation allowance or reserve created during the life of the project; considerations of deductibility and subsequent taxation of excess reserve; payments to subcontractors and the relevant tax considerations (withholding tax) | DTT provision for taxation of the excess decommissioning/ rehabilitation allowance/reserve; subcontractor's PE (or absence of) |

## Personal scope of tax treaties

The general principle of Article 1 is that tax treaties should apply only in respect of the persons (natural persons as well as legal persons, such as companies) that are residents of one or both of the Contracting States. Article 4 subsequently provides a definition of who is a resident of a Contracting State for treaty purposes and, in doing so, the Article refers back to the domestic law of the Contracting States.

Many extractive projects may be organized in the form of incorporated or non-incorporated joint-ventures (also known as consortia). Incorporated joint-venture projects would, in most cases, be carried out through a separate legal entity, which is usually subject to tax in its country of residence. This should not cause special issues in respect of the tax treaty application, with the exception of treaty shopping, which is addressed below.

Non-incorporated joint ventures may, in particular, give rise to questions related to the application of tax treaties. Non-incorporated joint ventures will operate not as one single legal entity, but as a contractual relation between several investors, where they jointly carry on the extractive activities and co-own both the assets and income arising from these activities. Consequently, they are also jointly liable for the costs related to the extraction project and potential liabilities. In such arrangements, one of the partners may be appointed as operator of the project, who will then be responsible for the accounting as well as operational aspects of the project; however, the tax liabilities are to be borne by each member of the consortium individually.

Such arrangements give rise to issues under domestic tax law and tax treaties. At the level of domestic law, issues of tax liability will be critical (i.e., are the partners of the consortium liable to taxation in both the source State and the residence State?). The consortium as such is generally not liable to tax. Under a tax treaty, one question will be whether the consortium will be entitled to benefits arising from the tax treaty (e.g., reduced rate of branch profit tax). Since non-incorporated joint ventures are contractual arrangements with several investors, they can be regarded as a “body of persons” for treaty purposes.<sup>30</sup>

---

<sup>30</sup> As stipulated in the United Nations Commentary to Article 3, citing the OECD Commentary, the term “person” should be interpreted very broadly.

The investors may also come from different jurisdictions, which can further complicate the issues. However, the tax treaty may only apply to those partners of the joint venture who qualify as residents of the Contracting States. This may lead to additional complicating issues, especially where only some of the partners of the joint venture are residents of the Contracting States; in such a situation there may only be a proportional entitlement to benefits arising from the tax treaties.

Another potential issue in the extractive industries is the “improper use” of tax treaties that include treaty shopping practices. In this respect, neither the United Nations Model Convention nor the OECD Model Convention provides specific provisions, although the Commentary to Article 1 explains how improper use of treaties may be combatted.<sup>31</sup>

In light of the OECD/Group of Twenty (G20) Base Erosion and Profit Shifting (BEPS) project,<sup>32</sup> it is likely that based on recommendations under Action 6, the Limitation of Benefits clause and/or a general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test) will become more widely used to counter treaty shopping. It is also advisable that developing countries consider domestic law anti-avoidance measures, which, as established in both the United Nations and OECD Model Conventions Commentaries, are acceptable and can be applied alongside treaty-based anti-avoidance measures, at least when they meet certain criteria.

Furthermore, it is recommended that countries establish measures of an administrative nature to enable the tax authorities to pre-screen transactions prior to the application of tax treaties. While such measures may on the one hand work as a natural deterrent to some of the most frequent treaty abuse practices; on the other hand, such measures may also create compliance and administrative costs.

---

<sup>31</sup> Addressed in the Commentary on Article 1 of both the United Nations and the OECD Model Conventions.

<sup>32</sup> The Base Erosion and Profit Shifting (BEPS) project was undertaken by the OECD on behalf of the Group of Twenty (G20) and proposed 15 Actions that are intended to provide countries with domestic and international instruments that will better align taxing rights with economic activity.



## Substantive scope of tax treaties

As noted earlier, with respect to most types of income relevant for the extractive industries, tax treaties aim to eliminate double taxation by limiting or eliminating source State taxation. Where the source State retains the taxing right and levies tax on the income, treaties oblige the State of residence to eliminate double taxation through the granting of a credit or an exemption.

Many countries have developed special tax regimes regulating the tax and compliance obligations of companies engaged in extractive activities. As different special taxes can be found in the extractive industries, the question arises as to which of these special taxes are covered by the scope of tax treaties. These special tax systems can be designed in different ways and can use different instruments, the characteristics of which may determine whether the particular type of tax may be covered by the scope of the tax treaty.

## Profit taxes

Some countries design their extractive taxation system using a profit tax as the main instrument, just as in other sectors. Some countries apply a higher-than-standard tax rate while others have separate income tax regimes addressing sector-specific issues. Alternatively, the countries use a special progressive tax rate scale for highly profitable operations (excess profit tax or windfall tax).

Box II.2:

### Example: Norwegian special petroleum tax

A special petroleum tax is levied on profits from petroleum production and pipeline transportation on the Norwegian Continental Shelf. The special petroleum tax is currently levied at a rate of 51 per cent. The special tax is applied to relevant income in addition to the standard 27 per cent income tax, resulting in a 78 per cent marginal tax rate on income subject to petroleum tax. The basis for computing the special petroleum tax is the same as for income subject to ordinary corporate income tax, except that onshore losses are not deductible from the special petroleum tax and a tax-free allowance, or “uplift”, is granted at a rate of 5.5 per cent per year. The uplift is computed on the basis of the original capitalized cost of offshore production installations. The uplift may be deducted from

taxable income for a period of four years, starting in the year in which the capital expenditure is incurred. Unused uplift may be carried forward indefinitely.

Those taxes levied on profits—such as corporate income tax, special surcharges on extractive companies and excess profit taxes—are usually covered by the scope of Article 2 (Taxes Covered). In order to avoid diverging interpretations by the competent authorities, the countries may seek to include special taxes applying to the extractive industries into the list of examples in Article 2, paragraph 3.

Box II.3:

**Example: Article 1 of the United States-Norway Income and Property Tax Convention**

(as amended through 1980)

The taxes that are the subject of this Convention are:

...in the case of Norway, the national and municipal taxes on income (including contributions to the tax equalization fund) and the special tax administered under section 5 of the Act of 13 June 1975, No. 35, relating to the taxation of submarine petroleum resources, as in effect on the date of signature of the Protocol to this Convention, and taxes substantially similar thereto enacted after such date.<sup>a</sup>

<sup>a</sup> United States-Norway Income and Property Tax Convention, Art. I, para. 2(a)(ii). Available at <https://www.irs.gov/pub/irs-trty/norway.pdf>.

## Bonuses

Bonus payments have to be paid for obtaining the right to explore or extract the natural resources. Bonuses are one-off (or sometimes staged) payments that may be fixed, the result of a bid, or negotiated, and are generally linked to particular early project events such as licence awards or signature. They provide early revenue to the government and are easy to administer, and as such, can be attractive from a government or resource-owner standpoint. From the investors' side, bonuses are often made in advance, potentially before knowledge of commerciality, and are unrelated to production and thus generally less attractive to investors. The bonuses are not levied with reference to profit; rather, they are payments for obtaining the exploration and

extraction rights, and they would therefore not normally be considered to constitute tax on income or capital, which could be covered by the scope of the tax treaty.

### **Royalties**

Royalties are the equivalent to the purchase price of the natural resource and entitle the extractive company to the ownership and subsequent sale of the natural resource. They are generally calculated as a percentage of the gross volume or value of the production and are due once production commences. With the exception of some countries,<sup>33</sup> royalties are not levied with reference to profit and they would therefore not be considered to constitute tax on income or capital, which could be covered by the scope of the tax treaty.

### **Production sharing contracts**

Production sharing contracts (PSCs) generally provide a formula for sharing the production between the investor and the government. They are used in the oil and gas industry especially, but mining PSCs do exist as well. A certain percentage of production is allocated to cover the actual investment and production costs borne by the investor (called “cost oil” in that industry) and the remaining amount is shared between the investors and the government (called “profit oil”). Profit oil may be the only payment to the government and it can be made in cash or in kind. Alternatively, the investor’s portion of the profit oil may also be subject to profit taxes imposed. Profit taxes imposed on the profit oil will usually fall within the scope of the tax treaty. However, especially where the source State obtains a larger in-kind allocation in lieu of taxes on the investor’s income, the treaty should clarify that this falls within the scope of the tax treaty.

In addition to the different types of special tax payments made by the extractive industries, there are the standard types of taxes that may relate to payments made to resident and non-resident employees, service providers or taxes applicable to profit distribution and other types of passive income. The type and nature of these traditional types

---

<sup>33</sup> South Africa determines the applicable royalty rate with reference to “earnings before interest”.

of taxes rarely raises issues regarding the substantive scope of the tax treaty. In the following table, the different types of taxes and obligatory payments to governments levied during the different stages of extractive industries activities are listed with indication of whether or not these types of taxes are to be covered by the scope of tax treaties.

If these special types of taxes are not covered by tax treaties (i.e., are outside of their scope) the host States can still levy these taxes, but conversely, the other Contracting States will have no treaty obligation to eliminate the potential double taxation by granting a credit or exemption. As no treaty limitations and obligations arise, this may lead to higher overall tax costs related to the particular investment and commercial activities. Therefore, many countries hosting extractive activities seek to design their tax systems in a way as to assure two objectives:

- (1) The country establishes and retains the taxing rights in respect of these extractives and related activities;
- (2) The taxes levied on the extractive activities can be credited in the investor's residence State.

In addition, the scope of the tax treaty provided for by Article 2 is also relevant for Article 25 (Mutual Agreement Procedure) unless the scope of this article is extended to include additional taxes not covered by Article 2. Articles 26 and 27 under the United Nations Model Convention apply to taxes of every description, not only taxes covered under Article 2. Therefore, the key question may often be whether the special levy is properly regarded as a tax for the purposes of the treaty.

Tax treaties usually cover taxes on income and on capital. Neither the United Nations nor the OECD Model Convention contains special provisions to address which special taxes applicable to the extractive industries shall be covered by a tax treaty. However, country practices indicate that some countries seek to include taxes levied on extractive activities in the scope of their tax treaties so long as these taxes meet the character of taxes on income or capital. To assure this outcome, countries may consider designing the relevant taxes to assure the nature of these taxes meet the character of taxes on income or capital. It is also appropriate to address the issue during negotiations, and to specifically state in the tax treaty that a special tax

Table II.2:  
Types of taxes levied at different stages of extractive project and the applicability of tax treaty

| Stages                                | Type of taxes and obligatory payments to governments | Typical characteristic                                                                                  | Covered by scope of double tax treaty (DTT)                                                                                               |
|---------------------------------------|------------------------------------------------------|---------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------|
| Contract negotiation and signature    | Signature bonus                                      | A payment in the form of percentage (e.g., 1% of expected value of natural resources) or a fixed amount | Usually not (unless the payment is designed in a way that it can be considered a tax on income credited against the corporate income tax) |
|                                       | Exploration bonus                                    | Similar to signature bonus                                                                              | Usually not                                                                                                                               |
| Exploration activities and evaluation | Rent payments                                        | Payments for the use of land                                                                            | Usually not                                                                                                                               |
|                                       | Tax levied on employees                              | Income taxes                                                                                            | Yes (taxpayer-individual)                                                                                                                 |
|                                       | Tax levied on service providers                      | Income taxes                                                                                            | Yes (taxpayer-subcontractor)                                                                                                              |
| Development of the infrastructure     | Bonuses and rentals                                  | Same as bonuses and rentals above                                                                       | Same as bonuses and rentals above                                                                                                         |
|                                       | Taxes on employees and subcontractors                | Same as taxes levied on employees and subcontractors above                                              | Same as taxes levied on employees and subcontractors above                                                                                |
|                                       | Import duties and levies, VAT                        | Indirect taxes and levies                                                                               | No                                                                                                                                        |

Table II.2 (cont'd)

| Stages                          | Type of taxes and obligatory payments to governments | Typical characteristic                                     | Covered by scope of double tax treaty (DTT)                          |
|---------------------------------|------------------------------------------------------|------------------------------------------------------------|----------------------------------------------------------------------|
| Extraction, production, export  | Royalties                                            | Payment on the volume or value of the extracted resource   | Usually not                                                          |
|                                 | Bonuses and rentals                                  | Same as bonuses and rentals above                          | Same as bonuses and rentals above                                    |
|                                 | Production sharing payments                          | Percentage of production paid to State                     | Usually not, unless designed as a tax on income/percentage of profit |
| Abandonment and decommissioning | Profit taxes and excess profit tax                   | Tax on income/profit                                       | Yes                                                                  |
|                                 | Export duties and export levies                      | Tax on value of exported resource                          | No                                                                   |
|                                 | Environmental fees or penalties                      | Fines or penalties for pollution                           | No                                                                   |
|                                 | Taxes on employees and subcontractors                | Same as taxes levied on employees and subcontractors above | Same as taxes levied on employees and subcontractors above           |
|                                 |                                                      |                                                            |                                                                      |

levied in the extractive industries is covered by the treaty. This will ensure a credit or exemption for such taxes.

In cases where special taxes in the extractive industries levied by the source State are covered by a tax treaty, the residence State has the obligation to apply Article 23 to eliminate double taxation. Some treaties specifically provide for special rules for the calculation of the maximum tax credit that the residence State must provide.<sup>34</sup>

### **Territorial scope of tax treaties**

Neither the United Nations nor the OECD Model Convention contains terms/definitions that would specifically address issues of the extractive industries. However, since many countries, in their practices, include the definition of “Contracting States” in Article 3, this definition determines the geographic scope of the application of the tax treaty. Such definition may include notions of territory and territorial waters, which are usually automatically included in the notions of state territory, but may also be expressly extended to include the continental shelf and exclusive economic zones within which the States may exercise taxing rights in accordance with international law.

The issue of whether or not to include specific reference to particular geographical areas in a tax treaty, as well as any potential consequences of such inclusion or non-inclusion, should be discussed during the treaty negotiations, and if necessary can be specifically addressed in the text.

### **Business profits and permanent establishment issues**

The profits from commercial activities will usually be covered by Article 7 (Business Profits) unless other articles apply to the specific type of income. Article 7 provides for exclusive taxing rights for the State of residence of the recipient of the income, unless the enterprise carries on business in the source State and such activities are conducted through a PE. In such a case, profits from such activities that are attributable to the PE may be taxed in the country of source. If economic activities do not fall within the definition of what constitutes a

---

<sup>34</sup> See, for example, Article 23 in the United States-Norway double tax treaty (DTT).

PE, the profits from such activities may only be taxed in the country of residence. This general rule and principle may not be suitable for the policy objectives of some countries that host extractive activities and therefore they may include specific provisions into their bilateral tax treaties, which may further alter these default rules of Article 7 and Article 5 to address these specifics.

The provisions of Articles 7 and 5 will be relevant for different actors in the extractive industries sector. These provisions will be important for the investors and operators, who may operate in the host country without having established an incorporated entity,<sup>35</sup> since existence of a PE will determine whether the country may levy tax on profits made by the investor, but these provisions will be also relevant for the various non-resident service providers and suppliers to this industry.

The term “permanent establishment” is an important threshold that is central to Article 7 and is defined in Article 5. However, it is also critical for the operation of other articles regulating the taxation of income such as dividends, interest, royalties, capital gains, income from employment as well as other income and capital. While this chapter addresses issues relevant for tax treaty negotiations generally, Chapter 3 (Permanent Establishment Issues) addresses more specifically the practical aspects of the permanent establishment concept in relation to the extractive industries.

“The term ‘permanent establishment’ means a fixed place of business through which the business of the enterprise is wholly or partly carried on” (Article 5(1) of the United Nations Model Convention). The condition that the place of business, or the use of it, has to be “permanent” is explained in the OECD Commentary (cited in paragraph 3 of the United Nations Commentary on Article 5(1)) in the sense that a PE can be deemed to exist only if the place of business has a certain degree of permanency (i.e., if it is not of a purely temporary nature). A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time because the nature of the

---

<sup>35</sup> Some countries (Brazil and Nigeria, for example) may require that the investor to be incorporated within the country to obtain a licence to explore or extract resources.



business is such that it will only be carried out for that short period of time. It is sometimes difficult to determine whether this is the case.<sup>36</sup>

In addition, Article 5(2) lists specific operations that *prima facie* constitute a PE. It especially includes “a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources”. The OECD Commentary to this paragraph (also cited in the United Nations Commentary at paragraph 5) states that “the term ‘any other place of extraction of natural resources’ should be interpreted broadly” to include all places of extraction of hydrocarbons, whether onshore or offshore. This is the only specific provision specifically addressing the extractive industries activities and the illustrative example indicates that extractive activities carried out by non-resident investors and subcontractors will usually constitute a PE in the source country. Thus, the income derived and capital owned in respect of operating a mine, oil or gas well, as well as any other place of extraction of natural resources by the non-resident enterprise, may be subject to tax in the country of source (the location of the natural resource).

The model provision, however, addresses only the extraction activities and does not address the issue of exploration activities. The OECD Commentary, which is also quoted in the United Nations Commentary at paragraph 5, offers in this regard several policy options to be addressed in bilateral negotiation:

15. The Contracting States may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:
  - a) shall be deemed not to have a permanent establishment in that other State; or
  - b) shall be deemed to carry on such activities through a permanent establishment in that other State; or
  - c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

---

<sup>36</sup> See 2017 United Nations () Commentary on Article 5, paragraph 3.

The Contracting States may moreover agree to submit the income from such activities to any other rule.<sup>37</sup>

Accordingly, some countries exercise this policy option and include exploration activities in Article 5(2) of their tax treaties.<sup>38</sup> Without providing any further rules, the general provisions of the permanent establishment definition (Article 5(1)) will apply to such exploration activities.

Alternatively, a treaty could provide for exploration to be a PE in a separate provision.<sup>39</sup> Such a provision may either provide that the exploration activities (onshore or offshore) are deemed to constitute a PE irrespective of the duration of activities. Other countries will include provisions with a specific time threshold<sup>40</sup>—for example, the 30-day rule, based on which the exploration activities deem to constitute PE if they continue for more than 30 days.

Both the United Nations and the OECD Model Conventions also have a provision dealing with construction sites. In this respect, however, the two models differ from each other: whereas Article 5(3) of the OECD Model Convention states that “a building site or construction or installation project constitutes a permanent establishment if it lasts more than twelve months”, the United Nations Model Convention gives the host country broader taxing rights by providing for a six-month duration test for building and construction PEs and expressly includes supervisory activities. This may be especially relevant in the extractive industries, since significant construction and installation of infrastructure takes place in the development stage. In the oil and gas industry, it is commonly understood that the well is being constructed, since it requires significant other construction activities beyond the mere drilling activity, including concrete works, welding, cementing, etc.

---

<sup>37</sup> Such an extraction provision can be found, for example, in Article 5(8) of the Canada-Papua New Guinea tax treaty, where activities in connection with exploration or exploitation of natural resources that last more than 30 days in total during a 12-month period will be deemed to constitute a permanent establishment.

<sup>38</sup> See, for example, Article 5(2)(f) of the Canada-Kazakhstan tax treaty of 25 September 1996.

<sup>39</sup> See, for example, Article 5(3)(3) of the Australia-China tax treaty.

<sup>40</sup> See, for example, Article 21 of the Nordic Convention.

Furthermore, some countries also deem a PE where “substantial equipment” is used “by, for or under contract” with the taxpayer.<sup>41</sup> Where countries introduce such provisions, interpretation issues may arise in respect to the term “substantial” equipment.<sup>42</sup>

### **Taxation of services**

As was noted above, a significant part of the activities related to exploration, development of deposits, and extraction activities are performed by various service providers and suppliers. The services carried out may encompass the drilling of wells (directional drilling, tubular running, cementing, etc.); logistics (communication, helicopter, logistic base, etc.); construction work, including maintenance and repair work, preventive maintenance, engineering; and consultancy services, catering, supply and hotel services. This naturally leads to questions, such as to what extent can the profits earned by the service providers and subcontractors be taxed by the source State, where these activities take place.

The host country is usually only allowed to tax a service fee paid to a subcontractor under the applicable tax treaty if (i) the non-resident subcontractor has a PE in the host country; and (ii) the service fee is attributable to the PE.

In this respect, the United Nations Model Convention contains special provisions, which are designed to provide the country of source extended taxing rights as compared to the OECD Model Convention. Specifically, under the United Nations Model Convention, a PE also encompasses a situation where services are furnished in the country, including consultancy services, by enterprises through employees or others for more than 183 days within any 12-month period (Article 5(3) of the United Nations Model Convention). This provision (often called the “service PE provision”) thus permits the country of source to levy taxes on business profits of enterprises without a fixed place of business in the source country, in case their activities in the source country exceed the 183 days threshold. As this threshold may still be

---

<sup>41</sup> See, for example, the DTT of Australia, Ghana and other mining countries; Article 4(3)b of the Australia-Singapore DTT; Article 5(3)c of the Australia-Switzerland DTT.

<sup>42</sup> See Australian Taxation Office, ATO Interpretative Decision 2006/306.

high for certain activities, especially in the extractive sector, a number of countries introduced a lower threshold for exploration activities as mentioned above. This also means that those activities, which would escape the “service PE”, would be considered to constitute a PE if such a special provision is included.

“Independent” agents may also constitute a PE when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, and are not dealing on an arm’s-length basis with the enterprise (Article 5(7) of the United Nations Model Convention).

By including these United Nations Model Convention provisions, countries significantly increase their right to levy tax on services provided in their territory.

Since there may be also significant amounts of profits earned by non-residents who do not have a significant presence in the country, have a high degree of mobility, or provide part or all of the services from outside the host jurisdiction, some host countries are increasingly applying a final withholding tax to service fees paid to non-residents without a taxable presence in the jurisdiction. The withholding tax may apply to independent services in general or be limited to the provision of “technical services”. On the one hand, final withholding on service fees offers some protection to the host country revenue against base erosion that may otherwise arise when service fees are paid to non-residents.<sup>43</sup> On the other hand, the gross income taxation may mean that the tax costs may exceed the net profit (where the profit margin is lower than the rate of the withholding tax) and thus can increase costs for the investors, because many of the service providers may insist that the cost of services should be increased to reflect these tax costs. Furthermore, in the State of residence no double tax relief may be granted for most of the withholding tax, since the tax liability exceeds the tax liability on the net income. However, some countries may provide the tax relief in any event.<sup>44</sup>

---

<sup>43</sup> See L. Burns, “Income Taxation through the Life Cycle of an Extractive Industries Project”, *Asia-Pacific Tax Bulletin*, vol. 20, no. 6 (18 November 2014), p. 401.

<sup>44</sup> Many countries also grant a credit for taxes paid on gross income. See, for example, Section 903 Internal Revenue Code for the United States and Section 34c Income Tax Act for Germany.

A host country wishing to maintain a withholding tax on fees for technical services may want to preserve its taxing right in its tax treaties. In cases where the host country wants to prevent treaty shopping by the subcontractor, an effective way would be to include a rule in the income tax legislation that generally confines the benefits of a tax treaty to genuine residents of the other Contracting State.

Furthermore, in order to retain the taxing right in non-abusive situations also, the host country may negotiate specific provisions in its tax treaties. For the treatment of services under tax treaties it is important that the United Nations Model Convention maintains Article 14 dealing with independent personal services. Accordingly, the host country is allowed to tax such income when a fixed base is available, or if the stay is for a period or periods amounting to or exceeding, in the aggregate, 183 days in any 12-month period, in addition to the taxation of business profits in case there is a PE in the host country. This threshold criterion thus raises similar issues like the threshold criterion of permanent establishment, and countries may wish to consider whether similar considerations in respect of specific types of permanent establishment, including the reduced time periods relevant for exploration/extraction activities, shall be introduced and applicable under Article 14.

Some countries include in their tax treaties special provisions covering income from “Technical Services,” which permits the country of source to levy tax on income derived by non-residents even if the time/location threshold is not exceeded (i.e., even when the PE/fixed base test is not met). Moreover, the United Nations Tax Committee decided to add a new Article to the United Nations Model Convention dealing with “fees for technical services”.<sup>45</sup> This proposed article will allow the host country to tax “technical services” up to a certain percentage of the gross amount even if the non-resident subcontractor does not have a PE in the host State. This type of provision significantly extends the taxing rights of the country of source as compared to other treaties and permits the country to levy tax on the services derived by contractors and subcontractors in respect of the services, which may

---

<sup>45</sup>United Nations Tax Committee of Experts on International Cooperation in Tax Matters, Report on the Tenth Session (27–31 October 2014). E/2014/45-E/C.18/2014/6, para. 74ff. It is Article 12A of the 2017 Model.

be provided in the process of exploration activities, consulting or other specialized services.

### **Article 6: Income from immovable property**

Article 6 allocates the right to tax income from immovable property to the State where the property is situated. Both the United Nations and the OECD Model Conventions state in Article 6(2) that the term “immovable property” shall have the meaning that it has under the domestic law of the State where the property is situated. “Rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources” shall in any case be considered as “immovable property”. “Working a resource” means removing the natural resources from the landed property.<sup>46</sup> Income from exploitation of natural resources is therefore, in general, taxable in the State where they are extracted.

In some treaties, a specific provision is included, often in a Protocol, clarifying that exploration and exploitation licences relating to natural resources shall be regarded as immovable property situated in the State to which they appertain (sometimes also deeming such licences to pertain to a PE situated in that State).<sup>47</sup> This means that the income derived by non-resident from the operations related to immovable property (including extractive activities) is subject to taxation in the country of source (location of the extractive activities) irrespective of whether the activities may constitute a PE or not.<sup>48</sup> This also has relevance for the ability of the host country to tax the capital gains from the sale of such licences.

### **Article 8: International shipping and air transport**

While Article 8 takes away the taxing rights from the country of source, some treaties have addressed the operation of tugboats and similar

---

<sup>46</sup> Ekkehart Reimer and Alexander Rust (Eds.). Klaus Vogel on Double Taxation Conventions (New York: Wolters Kluwer 2015) Chap. III, Art. 6.

<sup>47</sup> This can for example be found in the Protocol to the Croatia-Netherlands tax treaty of 23 May 2000.

<sup>48</sup> Article 6, paragraph 3 establishes that the provisions of Article 6 apply irrespective of the provisions of Article 7.

transport vehicles in the territorial waters and continental shelf by providing to exclude them from the possible scope of this Article.

It should be borne in mind that if the scope of the State has been extended to the continental shelf, any movements of boats, etc., between the onshore/harbour and a point on the continental shelf of the same State automatically falls outside the scope of Article 8 and the rules related to international traffic do not apply in respect of such activities.

Box II.4:

**Example: Article 6, paragraph 2 of the Singapore-UK Tax Treaty**

The term “international traffic” means all movements by a ship or aircraft operated by an enterprise of one of the Contracting States, **other than movements solely between places in the other Contracting State or solely between such places and one or more structures used for the exploration or extraction of natural resources situated in waters adjacent to the territorial waters of that other Contracting State.**

Countries may also want to ensure that they are not accidentally including other means of transport in the scope of this Article, as they may lose the taxing rights over different transport operators involved in the transport of natural resources, possibly giving up the right to tax significant profits that may arise from transporting natural resources.

### **Article 9: Associated enterprises**

While Article 9 foresees primary and corresponding adjustments in the situations where transfer prices depart from the arm’s-length price, considerations could be given to situations where the countries operate regulations requiring that the transfer price should not depart from a certain price set by regulatory bodies.

Such benchmark or reference prices are used by different countries in respect of hydrocarbons and minerals, and since discussion may arise as to whether these benchmark prices are an arm’s-length price, one could consider whether this specific aspect should be mentioned in the wording of Article 9 or should be provided as a clarification to Article 9 in the protocol to the treaty.

Chapter 5 of this Handbook addresses some of the specifics of transfer pricing in the extractive industries.

### **Articles 10, 11, 12: Dividends, interest, royalties**

These articles may not raise specific issues related to the extractive activities; nevertheless, they may still raise issues relevant to developing countries and tax base erosion.

There is a specific difference between the United Nations and OECD Model Conventions in Article 12 (Royalties), where the OECD Model Convention allocates the exclusive taxing right to the country of residence, while the United Nations Model Convention allocates the right to tax royalty to the country of source with a limited tax rate. In addition, the definition of Royalty in Article 12, paragraph 3 of the United Nations Model Convention extends the definition to include payments for the use of scientific, commercial and industrial equipment, thus permitting the country of source to levy tax on both payments for the use of intangible property and payments for the use of tangible property (including rental payment for the specific equipment used in the exploration, drilling, mining and other activities).

### **Article 13: Capital gains**

Capital gains from the sale of licence or similar rights to extract the natural resources as well as the sale of shares of companies who possess such rights may present significant tax revenue potential on the one side, as well as challenge for the extractive companies, since significant tax costs can be involved. Since this topic deserves detailed policy analyses, this chapter limits itself to some general observations. Chapter 4 of this Handbook (Indirect Transfer of Assets) addresses this topic in detail.

Article 13 generally mirrors the principles for allocation of taxing rights for particular types of income and allocates the right to tax gains from the alienation of assets to the country that had the right to tax income generated by these assets. Gains from the sale of the mineral resources extracted from or exploited in one Contracting State are therefore generally taxable in that State. Some countries have extended the taxation right for the situs State to also include maritime mineral deposits and assets in connection with the exploration and/or exploitation of such mineral resources offshore. Often, such provisions



are found in a separate article for the exploration and exploitation of hydrocarbon resources. For example, Article 21(9) of the Nordic Convention allocates the right to tax gains from the alienation of the right to survey and explore or exploit hydrocarbon deposits, including a right to a share in or profits from such deposits to the situs State.

In most cases of a direct transfer of a mining or petroleum right the source country would be allowed to tax the income from sale as gains from immovable property under the applicable tax treaty (assuming the licence is considered immovable property). It is, however, a common form of tax planning for non-residents to invest through a multi-tier non-resident corporate structure so as to facilitate a possible tax-free exit from the investment. Instead of directly selling a mine, a non-resident could avoid capital gains taxation by an offshore sale several companies up the line. Some countries (France, for example) therefore extend the definition of immovable property in Article 6 to include shares in companies deriving their value from immovable property. Consequently, Article 13(1) allows them to tax both the direct transfer of extraction/exploration rights and the indirect transfer of such rights via the sale of shares of companies, which possess such rights, if the natural resources are located in their country.

In this regard, it is also appropriate to highlight the existence of Article 13(5) of the United Nations Model Convention, which permits the country of source to tax the income from capital gains also where shares derive more than a specified percentage of their value from immovable property. However, the provision applies only in direct transfers of shares and comparable interests, so it may not be as effective in the indirect transfer situations.

In case Article 6 does not include shares in companies deriving their value from immovable property, the same result can be achieved by Article 13(4) of the United Nations Model Convention. It allocates the right to tax indirect transfers of immovable property to the source country where the immovable property is located. This rule applies, however, only when the value of the entity is derived “principally” from interests in immovable property in the jurisdiction. If the 50 per cent threshold is satisfied, then the whole gain is taxable. If a company is sold that holds interests in mining or petroleum rights in different countries, the arrangement could be structured in a way that the threshold is not

satisfied in relation to any country. Even if in such a case the gains of alienation of shares consist only of mining rights, none of the source countries might be allowed to impose a tax because the 50 per cent threshold must be fulfilled in respect to one single country. The impact of such tax planning can be limited by implementing a lower threshold.

Where the taxation of capital gains takes place from such indirect transfers of shares, it is appropriate to assure that the potential double taxation is relieved. This can take place through cost recovery methods or through measures in the country of residence of the seller.

In this respect, it is important to point out the limitation in the wording of the 2011 United Nations Model Convention, which limits the country of source to levy tax on such transfers, where the company is carrying on active business. In particular, Article 13(4) states that

[n]othing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.

This limitation may prevent the source State to levy a tax on capital gains from the transfers of shares of extractive companies. It was removed in the 2017 Model Convention. The issue of the operation of Article 13(4) is considered in more detail in Chapter 4 of this Handbook (Indirect Transfer of Assets).

### **Article 15: Dependent personal services**

The provisions of Article 15 provide an exclusive taxing right to the country of residence of the employee, with exceptions when the employee exercises the employment in the country of source and some of the conditions in Article 15, paragraph 2 are not met (the employee is present for more than 183 days in the country of source, or the salary is paid by an employer who is resident in the country of source, or the salary is born by the PE of the employer in the country of source). This also means that where the shorter time threshold (e.g., 30 days) applies to certain activities (such as exploration) the salaries of staff carrying out these activities (connected to the PE) become taxable in the State of source.

Assuming the PE definition in Article 5 takes into consideration the specifics of extractive industries (such as the short-term activities of various service providers),,, the provisions of Article 15 will automatically reflect the adjustments made by the definitions in Article 5 — especially, where the PE is deemed to exist immediately or after a short period of time (e.g., after 30 days) and thus no further changes are required to the tax treaty provisions. The host country will be able to tax the salaries of the personnel engaged in providing the services and activities where these activities constitute a PE, including the deemed PE, as a result of specific activities related to the extractive industries.

### **Articles 16 and 19: Director’s fees and government service**

In respect of Article 16 (Director’s Fees) it is advisable to follow the United Nations Model Convention, which extends the application of this article to the top management of companies.

One specific issue that may arise in respect of Article 19 (Government Services) is the establishment of a national oil and gas or mining company by a Contracting State. In this case, the activities of the Contracting State should be considered as those mentioned in Article 19, paragraph 3 and the provisions of Article 19, paragraphs 1 and 2 should thus not apply in respect of the remuneration received by the employees of these state companies.

### **Article 21: Other income**

The United Nations and OECD Model Conventions differ in respect of the allocation of taxing rights of other income. The type of income that is not covered specifically in other provisions of the tax treaty should be subject to tax in the country of residence (according to the OECD Model Convention)<sup>49</sup> and in the country of source (according to the United Nations Model Convention) when the income is paid from the country of residence.

Many countries prefer to follow the United Nations Model Convention version of Article 21, as situations may arise in which certain payments related to the extractive industries may fall into

---

<sup>49</sup> Except when this other income is attributable to the permanent establishment.

the category of Article 21 “other income” (e.g., various compensation payments, payments from insurance compensations, arbitration awards, etc., assuming a tax on these payments would fall under Article 21).

## **Article 22: Taxation of capital**

While Articles 6 to 21 of the United Nations and the OECD Model Conventions deal with the taxation of cross-border income of a recurrent nature, Article 22 of both models governs the taxation of capital in cross-border cases. In substance, Article 22 mirrors the treatment and definitions in the allocation rules related to corresponding items of income. It thus refers to the definition of immovable property in Article 6, the permanent establishment in Article 5 and the scope of Article 8 (Shipping and Air Transport). The meaning of such terms used in Article 22 is identical to the meaning of the same terms in the other treaty articles.

## **Article 23: Elimination of double taxation**

As was noted earlier, the elimination of double taxation through the methods of credit and exemption plays an important role in the extractive industries.

The specific issue related to the extractive industries would be the obligation of the country of residence to eliminate double taxation, where the country of source was entitled to levy tax on income or capital. Specifically, the question will arise as to whether the specific types of taxes levied on the extractive activities fall within the scope of the tax treaty, in accordance with Article 2, and whether the country of residence has to provide credit in respect of the particular type of tax. Countries of residence may seek to limit the maximum credit available as can be demonstrated from the example below.

Box II.5:

### **Example: Article 23 of the United States-Norway Income and Property Tax Convention**

#### **Article 23: Relief from double taxation**

The appropriate amount allowed as a credit by the United States shall be based upon the amount of income taxes paid or accrued to Norway.

However, the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. In addition, in the case of income taxes paid or accrued to Norway by persons subject to the special tax referred to in subparagraph 2(a)(ii) of Article 1 (Taxes Covered) or to a substantially similar tax, the appropriate amount allowed as a credit by the United States shall be limited to the amount of income taxes paid or accrued to Norway attributable to Norwegian source taxable income in the following way:

- (i) with respect to income taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway, the amount to be allowed as a credit for a taxable year shall not exceed the product of:
  - (a) the maximum statutory United States tax rate applicable to a corporation for such taxable year; and
  - (b) the amount of such income;
- (ii) further, the lesser of:
  - (a) the amount of taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway that is not allowable as a credit under subparagraph (i); or
  - (b) two percent of such income for the taxable year;
 shall be deemed to be income taxes paid or accrued in the two preceding or five succeeding taxable years, to the extent not deemed paid or accrued in a prior taxable year, and shall be allowable as a credit in the year in which it is deemed paid or accrued subject to the limitation in subparagraph (i);
- (iii) the provisions of subparagraphs (i) and (ii) shall apply separately, in the same way (but with the deletion, in the case of subparagraph (ii) of the words “the lesser of (a)” and “or (b) two percent of such income for the taxable year”) to the amount of income taxes paid or accrued to Norway on:
  - (a) Norwegian source oil related income not described in subparagraph (i); and
  - (b) other Norwegian source income.

## **Article 24: Non-discrimination**

Tax treaties contain the principle of non-discrimination, a principle that is also relevant for the extractive industries, since it prohibits

different and less favourable treatment in respect of taxation of permanent establishments (Article 24(3)) and discriminatory treatment in deductibility of certain expenses (Article 24(4)). Situations that may give rise to discrimination considerations include those cases in which the host country levies a higher tax rate on operators of the extractive industries. However, if this higher tax rate applies irrespective of the residence of the investor or the head office of the extractive company, they are not to be considered as discriminatory.

Similarly, where the host country levies a special branch profits tax, the issue may arise as to whether this branch profits tax is in accordance with a tax treaty. Country practices indicate that many countries chose to clarify these issues in Article 24(3) through a special provision inserted in Article 10 (Dividends) or in the protocols to the tax treaties.

Situations where the host country opts for indirectly taxing the non-resident subcontractor by denying a deduction for the payment of the fee at the level of the payer may be also considered discriminatory if similar payments made to resident recipients are deductible.

### **For more information**

- Catherine Brown, “Permanent Establishments and the Mining Industry—A Roadmap to the Taxation of Resource-Based Activities under Tax Treaties,” *Asia-Pacific Tax Bulletin*, vol. 18, no. 1 (16 January 2012), p. 5.
- L. Burns, “Income Taxation through the Life Cycle of an Extractive Industries Project,” *Asia-Pacific Tax Bulletin*, vol. 20, no. 6 (18 November 2014), p. 410.
- Philip Daniel, Michael Keen and Charles McPherson (Eds.), Philip Daniel, Michael Keen and Charles McPherson (Eds.), *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (New York: Routledge, 2010).
- Ekkehart Reimer and Alexander Rust (Eds.), *Klaus Vogel on Double Taxation Conventions* (New York: Wolters Kluwer 2015), pp. 310–311.

## Chapter 3

### PERMANENT ESTABLISHMENT ISSUES

#### Executive summary

This chapter examines the concept of permanent establishment (PE) in the extractive industries in detail. In this respect, it focuses on the main PE taxation issues relating to the extractive industries taking into consideration the relevant articles and Commentaries in the United Nations Model Convention (2017),<sup>50</sup> the Organization for Economic Cooperation and Development (OECD) Model Convention (2014) and the US Model Convention (2016).<sup>51</sup>

While reference is made to the mining sector as relevant, the chapter mainly deals with the PE concept in the oil and gas (O&G) sector where a wide array of taxation issues arises. This paper elaborates on the implications of recognizing the presence of a PE, distinguishing the tax consequences for the contractor and subcontractors as a result of the particular business features and different activities performed in a country.

The PE concept is one of the central elements of international taxation, particularly the law of tax treaties, and is primarily used for the purpose of the allocation of taxing rights when an enterprise of one State derives business profits from another State. The concept of PE is used in tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. Specifically, the profits of an enterprise of one State are taxable in the other State only if the enterprise maintains a PE in the latter State and only to the extent that the profits are attributable to the PE.

---

<sup>50</sup> The 2017 version of the UN Model is available at <http://www.un.org/esa/ffd/publications/model-double-taxation-update-2017.html>. The 2011 Model is available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).

<sup>51</sup> The relevant permanent establishment provisions of the OECD Model Convention are broadly included in the United Nations Model, with certain exceptions highlighted in this chapter.

Despite the fact that the concept of PE has a long history, its practical application still raises a number of issues as reflected by the numerous articles, case law and disputes between taxpayers and tax authorities on what constitutes a PE. Questions have been posed about whether the current wording of PE provisions in the Model Conventions (in their articles and the Commentary on them) remain sufficient to establish the proper allocation of taxing rights between the source State (State of the PE) and the residence State (State of the head office of the company itself). For example, the OECD has proposed updates to the PE notion and proposed changes to the Commentary under the Base Erosion and Profit Shifting Project, to prevent the artificial avoidance of PE status.<sup>52</sup>

Notwithstanding its strong physical presence in the source country—which leads to the existence of a PE—the extractive sector, and oil and gas activities in particular, comprise different phases and quasi-unique features and activities<sup>53</sup> that need to be examined on a case-by-case basis to determine the existence of a PE, based on the facts and circumstances involved.

In general, States enter into negotiations with oil and gas companies (contractors) regarding the primary economic aspects of the contract that specifies the extractive operations to be performed also referred to as the “work commitment”, which includes, for example, signature bonus, seismic acquisition and number of wells to be drilled).<sup>54</sup> Very frequently, these negotiations also address the fiscal regime that governs the allocation of revenues resulting from oil and gas activities (e.g., royalties, cost recovery, taxes, and government

---

<sup>52</sup> OECD (2015). *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7–2015 Final Report*. Available at <http://www.oecd.org/tax/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>. The 2017 OECD Model has made such changes and the 2017 United Nations Model has in many respects followed such updates.

<sup>53</sup> Exploration and production of hydrocarbons is characterized as highly intensive in capital investment with a low level of success in locating raw materials and, therefore, having a high level of risk.

<sup>54</sup> See also Chapter 8 (Tax Aspects of Negotiation and Renegotiation of Contracts).



participation<sup>55</sup>) that are applicable to such operations.<sup>56</sup> These contracts generally grant legal rights for exploration and production in a given delimited acreage (hereinafter referred to as contract or contractual area) which is normally managed by several oil and gas companies under a Joint Operating Agreement (JOA) (consortium or association) with normally one company appointed as the operator.

Another important aspect of the oil and gas sector is that a great number of subcontractors are normally hired by the company appointed as the operator in the JOA. The need for and use of numerous subcontractors is driven by the specialized and diverse types of work required on site where exploration and production activities take place (e.g., seismic work, drilling, casing, catering, logistics, and health, safety and environment (HSE)). PE issues with respect to drilling rigs deserve particular attention.

This chapter also makes reference to other aspects of PEs in the extractive industries that might be relevant for determining whether a PE exists and should be taxed; an example is the “services permanent establishment” (services PE) where a PE exists when an enterprise furnishes services under certain conditions within a source country through its employees or other personnel.

Accordingly, this chapter is structured in three main parts: the first part discusses the different sections of the United Nations Model Convention applicable to the oil and gas industry and how those provisions impact the different phases of the oil and gas production chain; the second part focuses on the construction work clause and how this clause applies to different relevant services performed by subcontractors; and the final part, structured to address several issues, identifies other elements of the United Nations Model Convention or activities in the sector that need to be taken into consideration when drafting a regulatory framework for the oil and gas industry.

## Purpose

The purpose of this chapter is to provide an overview of some of the

---

<sup>55</sup> Many systems provide an option for national oil companies to participate in development projects.

<sup>56</sup> See also Chapter 7 (The Government’s Fiscal Take).

most prominent aspects of PE taxation as applied to the oil and gas sector in particular. The issue at hand—the PE concept—is a very complex subject and the chapter only attempts to assist policymakers and administrators in developing countries in evaluating the different tax options available to them, taking into consideration overall implications of their decisions, with respect to some of the PE issues which tend to arise in the oil and gas sector.

## Background

When entering a country, oil and gas companies often structure their investment using a PE rather than incorporating a subsidiary. The main reason is generally based on non-fiscal motivations, as PEs provide more flexible commercial features than subsidiaries. As a general rule, a PE can be easier to set up and close down, making this structure more convenient for oil and gas companies that frequently enter into new countries without full knowledge of and experience in those countries' markets. If the investment turns out to be unsuccessful (e.g., there is no commercial finding during the exploration phase), the oil and gas company needs to smoothly withdraw from the block or contract area, sometimes leading to de-registering the branch.

Article 7(1) of the United Nations Model Convention provides that the business profits of a foreign enterprise are taxable in a State only if the enterprise has a PE to which the profits are attributable in that State. According to the Commentary to the United Nations Model Convention, this Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State if these profits are not subject to different rules under other Articles of the Convention.<sup>57</sup> It incorporates the basic principle that unless an enterprise of a Contracting State has a PE situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention specifically give taxing rights to that other State.

Article 5 of the United Nations Model Convention, which includes the definition of PE, is therefore critical to the determination

---

<sup>57</sup> United Nations, Department of Economic and Social Affairs (2017). United Nations Model Convention, Commentary on Article 7, para. 1.

of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. If economic activities do not fall within the definition of what constitutes a PE, the profits from such activities may only be taxed in the country of residence.

The United Nations Model Convention contains few specific provisions or commentary dealing with issues related to the tax treatment of PEs in the extractive industries. The general rules contained in various articles of tax treaties have, however, been applied by countries to specific situations in the oil and gas industry, giving rise to different interpretations about the existence of a PE in this respect. Furthermore, due to its special nature and a frequent desire to preserve taxation on oil and gas activity performed within their jurisdictions, several resource-rich countries have opted to include specific provisions regarding extractive industries in their tax treaties.<sup>58</sup>

Before the OECD released its final reports regarding base erosion and profit shifting (BEPS) on 5 October 2015,<sup>59</sup> the definition of PE had not been subject to major changes since its adoption by the League of Nations in the 1920s.<sup>60</sup> On the contrary, OECD Commentary on the articles of the OECD Model Convention, mainly reproduced by the United Nations Model Convention, have been changed on different occasions with respect to PE in order to, for example, create specific rules for a characterization of a services PE by countries wishing to have such a provision, or due to the progressive evolution of e-commerce (where, for example, the OECD 2008 Model Convention made changes which reflected the outcome of the OECD Technical Advisory Group created in 1999).

Notwithstanding the unchanged definition of PE in the OECD Model articles, divergent interpretations of the meaning of this term

---

<sup>58</sup> See, for example, Article 21 of the Nordic Convention. A special article for the exploration and extraction of hydrocarbons can be found in the treaties of Argentina, Australia, Denmark, Greece, Malta, the Netherlands, the United Kingdom of Great Britain and Northern Ireland, Ireland, Latvia, Norway, the United Arab Emirates and the United States of America.

<sup>59</sup> In particular, BEPS Action 7: Preventing the artificial avoidance of PE status.

<sup>60</sup> Double Taxation and Tax Evasion Report, League of Nations Doc. C.216.M.85 1927 II (1927).

can be found for similar situations in different countries. This could be due not only to their different fiscal interest or their capacity to develop the natural resources with companies established within the country (e.g., countries without the technology and know-how necessary to explore and exploit their resources versus those having such expertise and skills) but also to the fact that, in general, the concept of PE can give rise to different interpretations because of the language used in tax treaty models.

Exploration and production (E&P)<sup>61</sup> activities are usually carried out by oil and gas companies. Such entities are granted a licence either to explore and develop oil and gas in a delimited area within a country or to enter into agreements with the governmental authorities of a country to explore and exploit in a designated area in that country.<sup>62</sup>

The numerous kinds of contracts or fiscal arrangements (hereinafter referred as petroleum contracts) can generally be divided into the following: concession or licence contracts, pursuant to which the hydrocarbon belongs to the oil and gas company; PSCs, in which the State shares the results of the operation (government take) with the oil and gas company; or services agreements in which the State is the owner of the results of the operation but pays a fee to the oil and gas company for the services provided.<sup>63</sup>

While the ownership of the hydrocarbon is the fundamental distinction between a concessionary and contractual system, today

---

<sup>61</sup> Exploration & Production is the process that includes searching for and extracting oil and gas underwater or underground. It is generally known as the “upstream” process.

<sup>62</sup> Governments and O&G companies normally negotiate their interests in one of two basic systems: concessionary and contractual, with ownership (of the hydrocarbon) being the fundamental distinction. Under the concessionary system, the O&G company has title to the hydrocarbon produced. Under the contractual system, the government retains title to the resources. However, both systems may coexist in one jurisdiction (for the mining and the O&G sector or, even, for the O&G sector) or mixed systems (a system that shares features of both systems) may apply.

<sup>63</sup> For a more detailed information about contractual arrangements, please refer to Chapter 7 (The Government’s Fiscal Take) and Chapter 8 (Tax Aspects of Negotiation and Renegotiation of Contracts).

most of these petroleum contracts grant oil and gas companies the right to explore, develop, produce and market natural resources for a given delimited area and duration. The contractual area comprises a geographical area identified and delineated in the petroleum contract (i.e., the block or field).

As far as the extraction (production) of oil and gas is concerned, there is no doubt that the permanent character of this activity constitutes a PE. The problem generally concerns various other activities carried out in connection with exploration and exploitation of the natural resources. In this respect, among others, the following issues and their PE implications will be further developed in this chapter (not in the order specified):

- Illustrative list of PEs (“positive list”);<sup>64</sup>
- Studies or reconnaissance permits;
- Exploration activities;
- Existence of more than one PE;
- Registration of a branch;
- Representation office used for market research;
- Office used for supporting activities; and
- Consideration of non-operators as a PE.

Investors generally share the high investments and high risks involved in these projects by signing a JOA with other partners to carry on activities in the contract area. Under the JOA, one of the partners is designated the operator of the block and assumes responsibility for contracting the resources and subcontractors necessary to carry out the activities committed with the State under the petroleum contract. The other partners in most cases make cash contributions in proportion to their interest in the joint venture.

A very important aspect of PE relates to subcontractors hired to perform a wide range of activities at the source country. These subcontracting companies are characterized by their high degree of

---

<sup>64</sup> United Nations, Department of Economic and Social Affairs (2017). United Nations Model Convention, Article 5(2): “A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.”

mobility and how quickly they complete activities related to seismic issues, drilling, testing, maintenance, catering, engineering and/or consultancy services, among others. In principle, if not already established, their presence in a country will be temporary with no aim or need to continue once they have finished their work. The construction or installation PE clause<sup>65</sup> and its relevance in respect of, for example, drilling rigs, support vessels and other related services will be the object of analysis.

Long distance pipelines are used to transport oil and gas, sometimes crossing other countries and territories. The product is moved by pump stations along the pipeline. The PE tax treatment of this service of transport is also described in this chapter.

Certain countries have included specific provisions (“offshore clauses”) in their tax treaties that allow source-state taxation to a greater extent than the ordinary PE provision does. In this context, it should be noted that several member States of OECD have recorded reservations to offshore hydrocarbon exploration and exploitation and related activities, and have thereby reserved the right to insert provisions related to such activities in a special article of their treaties.<sup>66</sup>

Finally, mention will be made of the newly incorporated technical services provision, included in the 2017 version of the United Nations Model Convention as Article 12A (fees for Technical Services).

Countries should balance the pros and cons of all above-mentioned provisions, their adoption and application, according to their tax and economic policy and taking into consideration the country’s overall fiscal system. For example, if developing countries consider that introducing an “offshore clause” in their tax treaties is favourable as it extends the scope of PE taxation, they should also assess the cost-benefit balance of managing a greater number of PEs

---

<sup>65</sup> United Nations, Department of Economic and Social Affairs (2017). United Nations Model Convention, Article 5(3): “The term ‘permanent establishment’ also encompasses: (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months.”

<sup>66</sup> OECD, Model Tax Convention on Income and Capital, 2014, para. 47 of the Commentary on Article 5.

derived from the increased number of subcontractors that would fall under the conditions established in this clause.

Other means of achieving taxation on income obtained from activities that have reached a certain level of performance in the source country could be examined by developing countries. For example, a withholding tax could be imposed on cross-border payments (gross) that are deductible by the payer in determining tax on income. This system—which is part of a simpler and easier means of enforcement—reduces tax compliance costs for both the subcontractor and the source jurisdiction, but still requires a definition of a level of business required to trigger such withholding and the rate of withholding tax applicable to the payment. Other issues may be the fact that such payments could not be immediately deductible, not be deductible at any point (cost-oil) and that the payer may be required to be responsible for collecting and remitting the withholding tax.

It should be noted that to apply the appropriate taxation, income must first be characterized in the appropriate category. As mentioned above, several articles of the United Nations Model Convention might become relevant and disputes may arise between the taxpayer and the tax authorities over which would be the applicable treaty provision. For example, in a case related to the income tax treaty between India and the Netherlands, it was questioned whether the consideration paid by the Indian company to the Dutch company for the performance of an airborne geophysical survey fell within the definition of “fees for technical services” under Article 12 of such tax treaty.<sup>67</sup>

In summary, the United Nations Model Convention provides a number of provisions that allow States to design a competitive tax system aimed at the extractive industries, taking into account that several factors determine such competitiveness: structure and rate of taxes, cost recovery of business investment, tax rules for foreign earnings, the administrative cost for tax administrations and businesses (e.g., registration and de-registration procedures for tax purposes, filing tax returns on time, reporting tax liabilities, payment of taxes on time, auditing of returns, and effective and timely resolution of disputes), among others.

---

<sup>67</sup> De Beers India Minerals Pvt. Ltd. v. ITO, (2008) 113 TTJ (BANG) 101.

## The basic rule of permanent establishments

Article 7(1) of the United Nations Model Convention establishes that “the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein”. It is noted that paragraph 6 of Article 7 lays down a rule of interpretation in order to clarify the scope of application of this Article in relation to the other Articles dealing with a specific category of income. It follows from the rule that this Article will be applicable to business profits that do not belong to categories of income covered by the special articles on dividends (Article 10), interest (Article 11), royalties (Article 12) and other income (Article 21). It is understood that the items of income covered by the special articles may, subject to the provisions of the convention, be taxed either separately or as business profits, in conformity with the tax laws of the Contracting States.

The requirement for a PE or fixed base is, therefore, a threshold that needs to be satisfied before a source country can tax residents of other treaty countries on business profits. Unlike e-commerce, the extractive industries cannot be carried out remotely. Extractive activities require a fixed place of business or the physical presence of the contractor (e.g., the oil and gas company) and most subcontractors being in the source country.

Under the United Nations Model Convention, the examples of PE based on physical presence commonly include: a place of management, branch, office, factory, workshop, mining site, farm or forest, or a long-term building site. The examples of PE based on activity in the jurisdiction include the use of substantial equipment over an extended period, supervisory activities carried on over an extended period, and the presence in the jurisdiction of an employee for an extended period.

However, the PE concept does not have a harmonized application in practice and countries have applied and interpreted the PE thresholds differently with respect to taxing the extractive industries depending, in general, on the fiscal interests of the country<sup>68</sup> and the

---

<sup>68</sup> Arvid A. Skaar, Permanent Establishment. Erosion of a Tax Treaty Principle. Series on International Taxation (Wolters Kluwer: Boston, 1991) p. 3.



means available to collect the tax effectively.<sup>69</sup>

Under the definition included in Article 5(1) of the United Nations Model Convention (basic general rule) which is the same as Article 5(1) of the OECD Model Convention: “(...) the term ‘permanent establishment’ means a fixed place of business through which the business of the enterprise is wholly or partly carried on”.

Article 5(2) of the United Nations Model Convention, which is the same in the OECD Model Convention, sets forth a non-exhaustive list of concepts which often constitute a PE in the State in which they are located: “The term ‘permanent establishment’ includes especially: (a) a place of management, (b) a branch, (c) an office, (d) a factory, (e) a workshop, (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.” However, according to the Commentary to the United Nations Model Convention, it is assumed that States interpret the terms listed “in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1”.<sup>70</sup>

Accordingly, the following conditions a priori must be fulfilled to determine the existence of a PE.

### ***The “place of business” test***

A distinguishing feature of the PE for source-taxation based on the enterprise’s trade or business is the requirement of a “fixed place of business”. Article 5(1) of the United Nations Model Convention defines the term PE emphasizing its essential nature as a “fixed place of business” with a specific “situs”. Although there is no definition of “fixed place of business” as such in the United Nations Model Convention, the test is composed of three elements:

- (i) Determining if there is the existence of a “place of business”, i.e., a facility such as premises or, in certain instances, machinery or equipment;

---

<sup>69</sup> Brian J. Arnold. “Threshold requirements for taxing business profits” in: *The taxation of business profits under tax treaties* (Canadian Tax Foundation, 2003) p. 56.

<sup>70</sup> United Nations, Department of Economic and Social Affairs (2017). *United Nations Model Convention, Commentary on Article 5, para. 4.*

- (ii) This place of business must be “fixed”, i.e., it must be established at a distinct place with a certain degree of permanence; and
- (iii) The carrying on of the business of the enterprise through this fixed place of business. This means usually that persons (personnel) not “independent” of the enterprise conduct business in the State in which the fixed place is situated.

The mere fact that an enterprise has a certain amount of space at its disposal used for business activities is sufficient to constitute a place of business.<sup>71</sup> The place of business, however, has to be a fixed one. Thus, following the United Nations Model Convention Commentary, there has to be a link between the place of business and a specific geographical point. However, no physical attachment to the soil is necessary, something that may be pertinent for assets that can be regarded as connected to a certain site, as may be the case for drilling rigs.<sup>72</sup>

It is widely accepted that a PE is constituted only if the place of business remains at a “distinct” place, or a particular site. An extractive industry example referred to in the Commentary states that: “[a] mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business”.<sup>73</sup> Companies involved in the extractive industries often span a large geographical area. However, mining over a delimited area should constitute a single place of business, and the work done in that area should be considered to be taking place in a particular geographical location.

According to the Commentary on Article 5 of the United Nations Model Convention,<sup>74</sup> in order to have a single “place of business”, both geographical and commercial coherence is required. In

---

<sup>71</sup> Ibid., para. 3 of Commentary on Article 5 reproducing para. 4 of the OECD Model Convention.

<sup>72</sup> Ibid., para. 3 of Commentary on Article 5 reproducing para. 5 of the OECD Model Convention.

<sup>73</sup> Ibid.

<sup>74</sup> Ibid., para. 3 of Commentary on Article 5 reproducing para. 3 to 11 of the OECD Model Convention.

this respect, the geographical and commercial coherence is normally defined by each of the contractual areas where oil and gas companies perform their activities through different joint ventures within a country. For a more comprehensive explanation of the geographical and commercial coherence test, please see the geographical and commercial coherence test section of this chapter.

It should be noted that E&P activities in a country are normally established by oil and gas companies signing a single contract per geographical area with the corresponding governmental authority. Every geographical area subject to the exploitation (i) is usually separated and isolated from all others; (ii) may contain a different type of hydrocarbon (e.g., oil or gas); (iii) is participated in by different partners associated in a joint venture or association which is governed by a JOA; and (iv) often has different legal and tax regimes applicable to each petroleum contract depending on the date signed, as certain tax stability clauses may apply. Further, some countries establish a “ring-fence” rule by which profits in one area may not be offset against losses in another area.

The joint venture’s partners appoint one member as the operator of the area to carry out the E&P activities and execute the commonly agreed decisions. Every joint venture (i) performs the activity within the area in a self-standing manner; (ii) has its own accounting, independent from other contract areas; and (iii) has its own employees, equipment, work procedures and techniques. The head office registers its assets, liabilities, income, and losses attributable to the joint venture participants in accordance with their percentage of the participation.

In this respect, it is anticipated that every contractual area can be considered an independent PE, and, if ring-fencing applies under local law on the same basis, the investor would not be able to offset profits and losses from different contractual areas (e.g., where one area is incurring losses because it is under exploration and another area is obtaining profits because it is already in production). Some countries permit the consolidation of profits and losses from different contract areas (i.e., from different PEs) to make their regime more attractive for investments.

### ***“Permanence” test***

In order for a place of business to be “fixed”, it is also necessary that the presence of the business is not of a temporary nature. According to the

Commentary on Article 5 of the United Nations Model Convention,<sup>75</sup> while a six-month time limit is normally long enough for a business to be considered fixed, it is recognized that a PE may exist for a shorter period of time under certain circumstances.<sup>76</sup> However, States and domestic courts diverge when it comes to determining the minimum period of time needed to establish a PE.

In any event, oil and gas companies normally comply with the “fixed place” definition in Article 5(1) as most countries require a local presence for performing E&P activities and, given the expected timeline for E&P operations, that presence normally exceeds a year.<sup>77</sup> This test becomes more relevant with respect to subcontractors due to the shorter period they usually spend in the source country.

### *The “right of use/at the disposal” test*

Paragraph 3 of the United Nations Commentary on Article 5 (citing paragraphs 4 to 4.2 of the OECD Commentary on Article 5) explains that a place of business may constitute a PE of an enterprise if that place is “at the disposal of” the enterprise. Following the United Nations Commentary, “no formal legal right to use that place is (...) required”. The Commentary further clarifies that “[w]hilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise”.<sup>78</sup>

It is, therefore, generally accepted that no legal title is required to use a particular place of business. The Commentary on Article 5 of the United Nations Model Convention notes, in particular, that “[i]t is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise”.

---

<sup>75</sup> Ibid., para. 3 of Commentary on Article 5 reproducing para. 6 of the OECD Model Convention.

<sup>76</sup> Supra.

<sup>77</sup> A typical schedule would provide 6 to 8 years for exploration in 3 exploration periods. Duration for production should be a minimum of 25 years for oil.

<sup>78</sup> United Nations, Department of Economic and Social Affairs, op.cit., para. 3 of Commentary on Article 5.

Although not formally implemented in the 2014 or 2017 OECD Model Conventions, it is interesting to note that in 2012 the OECD proposed changes in the Commentary to the term “at the disposal”<sup>79</sup> to emphasize the fact that where an enterprise has an exclusive right to use a particular location, which is used for carrying on the enterprise business, that location is clearly at the disposal of the enterprise, and therefore leads to a PE:

Box III.1:

**2012 OECD-discussed changes in Commentary to the term “at the disposal”**

“4.2 [...] Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This is illustrated by the following example. Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities (e.g., where it has legal possession of that location) that location is clearly at the disposal of the enterprise.”

As mentioned above, the signing of a petroleum contract between the oil and gas company and the government is, in general, the starting point that leads to physical presence in a country. Such a contract entitles the oil and gas company to carry out E&P activities within a delineated geographical area. Notwithstanding the 2012 OECD proposed changes addressing legal rights as an element that satisfies the “at the disposal” test, certain tax treaties had already considered that the conferral of legal rights towards the exploration or extraction of natural resources gives rise to the existence of a PE:

***The “business connection” test***

An enterprise performing a “business activity” and maintaining a fixed place of business in another country may still not have a PE in

---

<sup>79</sup> Discussion draft of 19 October 2012 on Revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment).

such country. The PE definition establishes that the business activities must be carried on “through” a fixed place of business.

Box III.2:

**Examples of tax treaties referring to legal rights related to the extractive industries as a PE**

Protocol to tax treaty between the Netherlands and Oman of 5 October 2009

“VI. Ad Articles 5, 6, 7 and 13

It is understood that, for the purposes of this Agreement, **the rights** to the exploration, exploitation or extraction of natural resources granted by a Contracting State according to the laws of that State shall also be deemed to be a permanent establishment in that State, without prejudice to the laws of the Contracting States relating to the natural resources or the exploration, exploitation or extraction of those resources.”

Protocol to tax treaty between the Netherlands and United Arab Emirates of 8 May 2007

“V. Ad Articles 5, 6, 7 and 13

It is understood that exploration and exploitation **rights** of natural resources, including rights to interests in, or to the benefits of, assets to be produced by such exploration or exploitation, shall be regarded as immovable property situated in the Contracting State the sea bed and sub-soil of which they are related to, and that these rights shall be deemed to pertain to the property of a permanent establishment in that State and the profits attributable to the permanent establishment shall be taxable in accordance with the national tax laws and regulations of that State.”

According to the United Nations Commentary on Article 5, “the words ‘through which’ must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business ‘through’ the location where this activity takes place”.<sup>80</sup>

---

<sup>80</sup> United Nations, Department of Economic and Social Affairs, op.cit., para. 3 of the Commentary on Article 5 reproducing para. 4.6 of the OECD Model Convention.

To apply the “business connection” test “it is important to identify the party whose business is served by the place of business. In the extractive sector, the activity performed through the place of business may not be the business of the contractor, but of the subcontractors. This may give rise to one or more overlapping PEs in the same situs — one from the contractor (each contractual area is independently managed through the corresponding JOA) and, subject to its own tests, a PE of the subcontractor or subcontractors performing activities in the contractual area. For example, the subcontractor itself would have a PE at the site if its activities there last more than six months.

Even though the JOA appoints one of oil and gas partners as the operator of the block, non-operator partners would also be deemed to have a PE in the source country because the business activity carried out at the contractual area is regarded to be a joint business activity. It is important to note that typically all partners have signed the petroleum contract with the corresponding authority, generally being jointly responsible (according to their participating interest) and having their corresponding legal rights regarding the delimited acreage established in such contract. Therefore, non-operators will be regarded as having a PE and generally will pay their income taxes based on the financial information provided by the operator.

### **Exceptions to the notion of PE**

Article 5(4) of the United Nations Model Convention lists a number of business activities which are treated as exceptions to the general definition of PE laid down in paragraph 1 and which are not PEs (“negative list”) even if the activities are carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities and the reason for their exclusion could be found in the difficulties connected with the attribution of profits to such marginal business activities (which in most cases are cost centres).

The OECD Model Convention classifies as preparatory or auxiliary, *inter alia*, the activity of keeping a stock of goods and merchandise for storage, display, delivery or processing by another enterprise, as well as purchase of goods or merchandise and collecting of information for the use of the headquarters abroad.

In this respect, Article 5(4) of the United Nations Model Convention reproduces Article 5(4) of the OECD Model Convention with one substantive amendment: the deletion of “delivery” in subparagraphs (a) and (b).<sup>81</sup> The deletion of the word “delivery” reflects the majority view of the United Nations Tax Committee that a “warehouse” used for that purpose should, if the requirements of paragraph 1 are met, be a PE. Where an exclusion does apply, it is required that the activities be limited to the excluded activities. If an excluded activity is combined with a core business activity performed through the same place of business, a PE is created.

It is often difficult to distinguish between activities that have a preparatory or auxiliary character and those that do not. The decisive criterion is whether the activity of the business in itself forms “an essential and significant part of the activity of the enterprise as a whole”.<sup>82</sup> Each individual case will have to be examined on its own merits.<sup>83</sup>

---

<sup>81</sup> Article 5(4) of the United Nations Model Convention: “Notwithstanding the preceding provisions of this Article, the term ‘permanent establishment’ shall be deemed not to include (a) the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e) provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.”

<sup>82</sup> United Nations, Department of Economic and Social Affairs, *op.cit.*, para. 24 of the Commentary on Article 5, which reproduces the same paragraph of the Commentary to Article 5 of the OECD Model.

<sup>83</sup> In this regard, the Report on BEPS Action 7 proposed to add to the Commentary that “[a]s a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what



Typical PE issues that may arise concerning the application of Article 5(4) of the United Nations Model Convention in the extractive sector are those related to representative offices, warehousing and pipelines, which are discussed below.

***Application to phases of extractive industries project life cycles***

The stages of a typical extractive industry project can be divided into the following phases: (i) licensing; (ii) exploration; (iii) appraisal; (iv) development; (v) production; (vi) abandonment; and (vii) activities to be performed after abandonment (primarily decommissioning). Each of these phases has a particular level of uncertainty (e.g., geological, financial and political) associated with it.

Figure III.1:  
**Phases of extractive industry project**




---

constitutes the essential and significant part of the activity of the enterprise as a whole. [...] An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole”. This is now included as paragraph 60 of the 2017 OECD Model’s Commentary on Article 5.

*Licensing activities**Representative office*

It is quite common for oil and gas companies initially to establish a representative office instead of, or prior to, registering a branch. The representative office performs market research, coordination or other limited non-income generating activities. In this regard, many representative offices are established to look for oil and gas opportunities (i.e., information gathering) in the country of establishment or in other countries within the region.

Jurisdictions may adopt different views with regard to the nature of the activities performed by representative offices. To the extent that representative offices do not sell goods or services generating income, many countries do not regard them as PEs and, accordingly, they are not subject to corporate income tax due to the presumed non-income nature of their activities. However, under their own domestic law, other countries consider that a representative office does constitute a PE and, therefore, is subject to tax.

It should be noted that the representative office may operate over a protracted period of time and representative offices might become branches (in the countries which do not automatically regard them to be PEs) if the activities ultimately go beyond those of a mere preparatory or auxiliary nature.

*Joint studies/reconnaissance contracts*

Market surveys and the collection of other information about a foreign country normally constitute the first step towards a more substantial engagement. Many countries sign certain types of contracts (joint studies, reconnaissance contracts, etc.) with oil and gas companies, allowing for geological surveys in a delimited area. These contracts are precursors to a government offering petroleum contracts, with study participants having certain priority rights (e.g., the right to match the highest bid for any resultant petroleum contact in an area wholly or partly overlapping the area of the survey).

According to the Commentary to Article 5<sup>84</sup> of the United

---

<sup>84</sup>United Nations, Department of Economic and Social Affairs, op.cit.,

Nations Model Convention, should preparatory activities lead to core business activities, a PE could be constituted retrospectively from the date it started the first activities. A PE begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that the preparatory activities differ substantially from the activity for which the place of business is to serve permanently.

In this regard, certain countries have considered that geological surveys that lead to signing a petroleum contract by the same participants would be a PE from the start of the survey. Other countries have considered that each type of contract (the geological survey and the petroleum contract) has a different scope and that it cannot be inferred that the survey contract directly led to the award of the petroleum contract (since the survey contract only grants a priority right and the contractual area does not always completely overlap the whole survey area). In the latter case, in those countries the PE only begins to exist when the petroleum contract is signed, and expenses incurred during the survey normally cannot be set off against future profits derived by the PE.

### *Place of management, branch and office*

The “positive list” in Article 5(2)(a) 5(2)(b) and 5(2)(c) of the United Nations Model Convention gives examples of PEs with a characterization of the enterprise’s use of the place. This is the case for branches, offices and places of management.

Once an oil and gas company has been awarded a petroleum contract, and sometimes even before, as required by domestic legislation, a branch is registered. The registration does not create presence by itself, but the oil and gas company usually sets up an office in a main city of the country in order to represent the company before the corresponding authorities as well as to provide certain support to the E&P activities carried out within each particular area. The activities provided by the office are typically those carried out by a coordination

---

para. 3 of the Commentary to Article 5 reproducing para. 11 of the OECD Model Convention.

centre, which includes corporate functions (i.e., accounting, administration, finance, human resources, treasury, information and communication, technical support, and supervision activities).<sup>85</sup>

In general, domestic legislation requires the registration of branches, but the relevant element for determining the existence of a PE is whether the branch has an office. This office is usually registered as a branch and, therefore, the office is designated as a branch office in the country. The same applies in certain countries to contractual areas that likewise are registered as branches.

The place of management is a place where the business of the whole or part of the enterprise is conducted. When the business is conducted from various places, each place may constitute a place of management. It usually presupposes the existence of an office or other facilities, following the Commentary to the United Nations Model Convention,<sup>86</sup> but must not be confused with the term “place of effective management”, which is the absolute centre of management of the enterprise. Therefore, a place of management can be identified as the part of the enterprise where certain key decisions are made, but not to the extent that all important decisions for the business are made through such an establishment.

### *Exploration activities*

Article 5(2)(f) of the United Nations Model also lists the following as examples of places that will often constitute a PE: a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

In discussing this subparagraph (f) the Commentary states that “the term ‘any other place of extraction of natural resources’ should be interpreted broadly” to include, for example, all places of extraction of hydrocarbons whether on or offshore.

---

<sup>85</sup> Jan de Goede and Ruxandra Vlasceanu, *Permanent Establishment Implications for Coordination Centres in the Oil and Gas Industry*, IBFD Bulletin for International Taxation, (September 2013), p. 466.

<sup>86</sup> United Nations, Department of Economic and Social Affairs, op.cit., para. 24 of the Commentary to Article 5: “(...) a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2”.

While the example makes reference to oil or gas wells, oil and gas companies ordinarily operate within delimited areas, which are geographically identified in the petroleum contract signed with the State's government. The commitments included in the petroleum contract could vary from drilling no wells (e.g., just seismic works) to drilling one or more exploration wells during the exploration phase. Following the Commentary—in the sense that a broad interpretation should be given of the term “place of extraction of natural resources” and, therefore, the PE—in the oil and gas sector, the PE will normally be the contractual area where activities are performed through a joint venture or association which is governed by a JOA, rather than each of the wells drilled within the contractual area.

While “exploitation” activities would always be taxable in the source country under Article 5 of the United Nations Model Convention, exploration activities are not mentioned in subparagraph (f). In this regard, Article 5(1) of the United Nations Model Convention will govern whether exploration activities are carried on through a PE.

The United Nations Model Convention reproduces the OECD Commentary<sup>87</sup> which states that Contracting States: “may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State: a) shall be deemed not to have a permanent establishment in that other State; or b) shall be deemed to carry on such activities through a permanent establishment in that other State; or c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time. The Contracting States may moreover agree to submit the income from such activities to any other rule”.

In this respect, many treaties merely reproduce Article 5(2) of the United Nations Model Convention without specifying whether “exploration” activities are considered as constituting a PE. In such cases, as mentioned above, the basic rules contained in paragraph 1 of Article 5 of the United Nations Model Convention shall govern whether exploration activities are carried out through a PE.

---

<sup>87</sup> United Nations, Department of Economic and Social Affairs, *op. cit.*, para. 5 of the Commentary to Article 5 reproducing para. 15 of the OECD Model Convention.

Examples with respect to items of the above-mentioned Commentary that expressly include exploration activities in Article 5 of the treaty are widely found in bilateral tax treaties:

Box III.3:

**Examples of treaties that expressly include “exploration” in the definition of PE**

*Article 5(1)(f) of the tax treaty between Gabon and Canada of 14 November 2002:*

“...a mine, an oil or gas well, a quarry or any other place relating to the exploration for or the exploitation of natural resources.”

*Article 5(1)(f) of the tax treaty between Iran and the Slovak Republic of 19 January 2016:*

“...a mine, an oil or gas well, a quarry or any other place of exploration, exploitation and/or extraction of natural resources.”

Other countries have preferred to include the alternative proposed under item c, which considers a PE to exist if exploration activities last longer than a specified period of time:

Box III.4:

**Example of a treaty that considers “exploration” activities as a PE if such activities last longer than a specified period of time**

*Article 5(3) of the tax treaty between Spain and Kuwait of 26 May 2008:*

“The term permanent establishment also encompasses any place relating to the exploration of natural resources, provided such activities exists for a period or periods aggregating more than six months within any twelve-month period.”

A particular case is Article 5(3) of the United States Model Income Tax Convention, which departs from the United Nations and the OECD Model Conventions and includes an express rule for drilling rigs and ships used for the exploration of natural resources for a period of longer than 12 months:

Under an E&P project (new ventures and business development, exploration, development and production), the exploration does not always result in a hydrocarbon discovery that is followed by a

development and production phase. As a result, the activity is frequently discontinued with no income having been generated. The associations, joint ventures or consortiums set up by the companies that participate in each contractual area, after a technical and economic analysis, take the decision to terminate the exploration of the contractual area or let the contract expire. Discontinuation or transfer to a third party of an E&P related PE will be considered to cease the existence of the E&P for the oil and gas company at the time the decision on the termination of the exploration was taken and notified to the relevant authorities.<sup>88</sup> The notification to the authorities is also the moment the E&P company's right of disposal of the contractual area ends, since following that notification the government could offer such area to new investors.

Box III.5:

**Example under the United States Model Income Tax Convention**

***Article 5(3) tax treaty between the United States of America and Malta of 8 August 2008:***

“A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration of natural resources, constitutes a permanent establishment only if it lasts, or the exploration activity continues for more than twelve months.”

### *Development*

When an exploration prospect results in a commercial discovery, the development phase starts. Unlike the exploration phase where other companies may typically join the project (farm-in/farm-out agreements) paying a prorated share of exploration costs or providing a carry of certain future exploration costs<sup>89</sup> to the initial exploration company, once a commercial discovery is realized, the value of the

---

<sup>88</sup> For example, binding tax ruling of 9 December 2015 of the Spanish General Directorate of Taxes (number V3926-15), under which the discontinuation of a PE of an O&G company occurred at the time the decision on the termination of the exploration was taken, and such decision was notified to the relevant authorities.

<sup>89</sup> Those conducting the exploration are able to get reimbursement on a portion of past costs, typically geological and geophysical (G&G) work.

project increases. While farm-in/farm-out agreements are still possible in the development phase, depending on a country's tax laws, such agreements, and especially outright sales of interests in the licence, may give rise to capital gains attributable to a disposition of immovable property and business assets used in a PE situated in the source country (see Chapter 4 on the Indirect Transfer of Assets). The same treatment would follow under the production phase as a PE exists.

### *Production*

After development is completed, production activities begin, in which hydrocarbons are extracted from the reservoir, refined and sent to market by pipeline or ship. The productive life can last decades and the reservoirs are continuously monitored to optimize production. The extraction of hydrocarbons could take place onshore or offshore, being that onshore production is more economically viable and is less elaborate and more cost-effective. A whole range of different structures is used offshore, depending on size and water depth.

There is no doubt that the oil and gas company will have a PE during the production stage, whereas the different subcontractors that perform activities at the site would have a PE depending on their specific facts and circumstances.

### *Abandonment*

In general, a site continues to exist until the work is completed or permanently abandoned.<sup>90</sup> Therefore, the PE will continue to exist for the oil and gas company during the development and production phases until completion of production (COP) has been declared and the "well plug and abandon" operations have been performed. However, the oil and gas may continue to have a PE during the decommissioning phase as explained in the following paragraphs. It should be noted that no income will arise during the decommissioning phase but, depending on the tax regime, it could be relevant for the oil and gas company or the source country to maintain the existence of a PE.

---

<sup>90</sup> United Nations, Department of Economic and Social Affairs, op. cit., para. 11 of the Commentary on Article 5, which reproduces paragraph 19 of the OECD Model Convention.



### *Decommissioning*

As the oil and gas reservoirs become depleted, however, the facilities require decommissioning and remediation (see Chapter 6 on the Tax Treatment of Decommissioning). During this phase, even if the oil and gas company may have returned the block to the government, it is normally responsible for the decommissioning and remediation work.

With respect to subcontractors hired to perform the decommissioning work, it seems clear that they will have PEs at the site if their activities there last more than six months, as established in the construction work clause (see the construction work clause section below).

This has been the approach adopted, for example, by the Income Tax Rulings Directorate of Canada in response to a letter dated 27 June 2016, in which the taxpayer asked whether a “building site or construction or installation project” exists at a location where a structure is being dismantled or decommissioned regarding a number of offshore oil and gas platforms.

As a technical explanation, the Canadian Tax Directorate response of 16 January 2017 noted that Article 5(3) has nothing that would suggest that that dismantling or commissioning activities (referred to as “demolition”) would not fall under the construction PE provision. It quoted the work of Professor Klaus Vogel to indicate that “[t]he term ‘building site or construction project’ also covers demolition and clearing operations” and concludes that the decommissioning work would likely be considered to fall under the scope of the construction PE Provision.<sup>91</sup>

With respect to the oil and gas company, the existence of a PE could derive from the situation described in paragraph 54 of the Commentary on Article 5 of the United Nations Model Convention, which states that “[i]f an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts parts of such a project to other enterprises (subcontractors) the period spent by a subcontractor working on the building site must be

---

<sup>91</sup> 16 January 2017 External T.I. 2016-0655701E5 — Article 5(3)—Demolition, citing *Klaus Vogel on Double Taxation Conventions*, 3rd ed. (Cambridge, MA: Kluwer Law International), at 306; available at <https://taxinterpretations.com/node/453050>

considered as being time spent by the general contractor on the building project”. It is relevant to note that due to its complexity and size, the contractor normally performs “supervisory activities”, which are expressly included in the PE concept under Article 5(3)(a) of the United Nations Model Convention: “[a] building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months”.

### **The construction work clause**

Following Article 5(3)(a) of the United Nations Model Convention, the term PE also encompasses “a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months”.

Article 5(3) of the United Nations Model Convention covers a broader range of activities than Article 5(3) of the OECD Model Convention, which states: “[a] building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months”. In addition to the term “installation project” used in the OECD Model Convention, subparagraph (a) of Article 5(3) of the UN Model Convention includes an “assembly project” as well as “supervisory activities” in connection with “a building site, a construction, assembly or installation project”. However, while the OECD Model Convention uses a time limit of 12 months and the United Nations Model Convention reduces the minimum duration to six months, these periods could be reduced in bilateral negotiations, generally to no less than three months.

The period of time under the construction PE provision may, accordingly, be agreed by contracting States and may vary from one treaty to another:

Box III.6:

**Examples of tax treaties specifying a different time period under the construction clause**

**Article 5(3) treaty between Morocco and the United Arab Emirates of 9 February 1999:**

“The term ‘permanent establishment’ also encompasses:

(a) a building site, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than eight months.”

**Article 5(1)(g) treaty between Jordan and Romania of 10 October 1983:**  
“...a building site or construction or assembly project which exists for more than seven months.”

**Article 5(3) treaty between Austria and South Africa of 4 March 1996:**  
“A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.”

The Commentary on Article 5(3) of the OECD Model Convention, reproduced in the United Nations Model Convention, extends the scope of the definition of construction to “the laying of pipe-lines and excavating and dredging”.<sup>92</sup> Likewise, as mentioned above, drilling activities are treated as construction work with a similar “duration test” in many treaties which adopt rules similar to that in the United Nations Model Convention.

The difference between the basic rule in Article 5(1) and Article 5(3) of the United Nations Model Convention is that the latter provides an explicit definition of the duration, turning the “permanence test” of the basic rule into a “duration test”, as a construction site is by its very nature temporary.

The purpose of this provision is to allow taxation of PE activities that do not last for an indefinite period of time. In this respect, a construction site is by definition not intended to be permanent. In addition, while construction tasks usually have an undisputable location, certain works will not be performed at one specific place, because the site will be moved as the work proceeds (e.g., road construction or pipeline laying). However, as mentioned by the Commentary on Article 5(1) of the United Nations Model Convention,<sup>93</sup> the words “through which” must be given a wide meaning so as to apply to any

<sup>92</sup>United Nations Model Convention Commentary on Article 5, paragraph 15.

<sup>93</sup>United Nations, Department of Economic and Social Affairs, op. cit., para. 3 of the Commentary on Article 5 reproducing para. 4.6 of the OECD Model Convention.

situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.

As previously noted, it is not generally significant for oil and gas companies whether Article 5(1) or the construction work clause established in Article 5(3) of the United Nations Model Convention applies. E&P activities of oil and gas companies by definition have local presence that constitutes a PE or more than one PE within the source country and, in any case, would exceed the time thresholds of most construction clauses.

But, as noted, numerous subcontractors perform various activities in the contractual area. The type of services and supplies rendered are of a very different nature and, generally, separate contracts are signed with each of the subcontractors, the most important being the drilling activity.

Identification of construction works has been a concern for many countries in order to protect the taxable base. Such identification can be justified if different works form a commercially and geographically coherent whole. Both the commercially and geographically aspects of this “coherent whole” test need to be met as, under the United Nations Model Convention Commentary,<sup>94</sup> “where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business” and what constitutes a “coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business”.

As further explained below, the United Nations Model Convention includes a subparagraph (b) in Article 5(3) providing a specific provision in relation to the furnishing of services by an enterprise through employees or personnel engaged for that purpose.<sup>95</sup>

---

<sup>94</sup>United Nations Model Convention Commentary on Article 5, paragraph 3.

<sup>95</sup>United Nations, Department of Economic and Social Affairs, *op. cit.*, para. 3(b): “The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods agree-

According to the Article 5 Commentary, the reason for including the rationale of this subparagraph is that “[m]any developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits”.<sup>96</sup>

The Commentary on Article 5 of the United Nations Model Convention, at paragraphs 11 and 12, deals with those situations where: “taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects”.

It should be mentioned that certain countries have included in their tax treaties special provisions stating that the oil and gas offshore activity constitutes a PE if it lasts for more than 30 days, notwithstanding the other provisions of the treaty. This specific “offshore clause” does not require the geographical test, as any activity performed within the offshore area could lead to the existence of a PE.

### *Drilling activity*

Many types of platforms exist depending on the circumstances. In general, platforms may be fixed to the ocean floor or may float. Fixed platforms are fixed to the same geographical area for long periods of time and, therefore, satisfy the “fixed” test. Whether mobile drilling rigs are considered to comply with the “fixed” test should be considered on a case-by-case basis. Drilling rigs can remain in the same spot for a long period of time or just a couple of months. It could also happen that more than one well is drilled in the same contractual area of the oil and gas company, either on a back-to-back basis or in different time periods.

Following the criteria that each contractual area (field or block) constitutes a PE of the oil and gas company and complies with the geographical and commercial coherence test, a drilling rig moving

---

gating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned”.

<sup>96</sup>United Nations Model Convention Commentary on Article 5, paragraph 9.

around in the same oil field would, therefore, satisfy the conditions of a PE if the activity lasted more than six months under the United Nations Model Convention definition. The actual duration, not the intended one, should be the relevant standard and, therefore, if a drilling activity is intended to last four months but ultimately lasts for more than six months, the activity should be considered to meet the PE timing criteria.

A general point of clarification is given by the Commentary on Article 5 of the United Nations Model Convention reproducing the OECD Commentary:<sup>97</sup> “(...) no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it”.

It can normally be assumed that works conducted under the same contract will be considered a coherent whole, but to address any possible abuse derived from signing several contracts with different durations, the United Nations Model Convention reproduces what the OECD Commentary observes, with changes noted in parentheses to take account of the different time periods in the two Models: “The [six]-month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations”.<sup>98</sup>

The start of the duration test is relevant in this short-term works context where a single day’s difference could lead to the establishment of a PE. The issue is to decide when a construction or installation actually starts and terminates. With respect to drilling rigs, relevant work normally commences on “spud day”—when the process of beginning to drill a well starts—and ends when the well has been completed.

---

<sup>97</sup> United Nations, Department of Economic and Social Affairs (2017) *op. cit.*, Commentary on Article 5, para. 11.

<sup>98</sup> *Ibid.*

Owners of rigs may provide drilling services by way of a time charter, whereby the owner provides the rig with full crew to operate the rig, or on a bareboat basis, just renting the rig itself, often to a related company. If rent for equipment is classified as a royalty under a treaty definition (the United Nations Model Convention Commentary defines royalties to include payments for the rental of industrial, commercial or scientific equipment<sup>99</sup>) the royalty provisions apply unless the rent is beneficially owned by a resident of the other contracting state that carries on business in the source State through a PE in that State and the rent is effectively connected to that PE.

Box III.7:

**Article 12 (Royalties) of the tax treaty between Canada and Denmark of 17 September 1997**

“4. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright, patent, trade mark, design or model, plan, secret formula or process or for the **use of, or the right to use, industrial, commercial or scientific equipment**, or for information concerning industrial, commercial or scientific experience, and includes payments of any kind in respect of motion picture films and works on film or videotape or other means of reproduction for use in connection with television.”

In a Norwegian case dealing with leasing out of equipment in the offshore industry,<sup>100</sup> the Supreme Court held that the rental of a drilling rig on bareboat terms was insufficient to cause the rig owner to be taxable in Norway as the rig owner did not take part in the risk of operating the rig. The case refers to two foreign companies, Tric and Trag, that were controlled by the same owners. Tric (resident in Liberia) was the owner of a drilling rig that was hired out on a bareboat charter to Trag, and Trag (resident in Switzerland) operated the rig on the Norwegian Continental Shelf and was liable to tax in Norway for that activity. The

---

<sup>99</sup>In 1992, the OECD Model Convention was revised to remove equipment rentals from the definition of royalties. However, some OECD member countries entered reservations to Article 12 of the Model to maintain a limited right to tax royalties at source, including rents paid for the use of equipment.

<sup>100</sup>NO: HR, 1997, Tric/Trag, Rt 1997, at 1646.

tax authorities argued that Tric and Trag carried out joint activities in Norway and that Tric took part in the business activity that was taxable in Norway. For its part, Tric argued that it merely hired out the rig to Trag and that hiring out equipment to a Norwegian entity did not constitute taking part in joint business activities in Norway.

It was undisputed that Trag engaged in a business activity that was taxable in Norway as a PE under the offshore clause. However, as Norway does not have a tax treaty with Liberia, the dispute in respect of Tric was decided only on the basis of Norwegian domestic law. In this case, the Supreme Court ruled in Tric's favour as it considered that the mere lease of a rig on a bareboat charter for use in Norwegian waters did not constitute participating in an activity in Norway and the activity was not performed for the joint account and under the joint liability of the parties, irrespective of the close cooperation between both companies. Consequently, Tric was not considered to have a PE in Norway.<sup>101</sup>

In another case, the Canadian Income Tax Rulings Directorate, Legislative Policy and Regulatory Affairs Branch of Canada concluded in an advance income tax ruling<sup>102</sup> that entering into a bareboat agreement for a ship to be used in Canadian waters could not be regarded as constituting a PE.

In some tax treaties, the use of “substantial equipment” in the source country has been included in the definition of a PE. In these cases, bareboat agreements could lead to the existence of a PE. Examples of treaties that have included “use of substantial equipment” in the definition of PE follow:

Box III.8:

**Article 5(4) of the tax treaty between Australia and South Africa of 1 July 1999 (as amended in 2008):**

“... where an enterprise of a Contracting State:

- (b) carries on activities (including the operation of substantial equipment) in the other State in the exploration for or exploitation of

<sup>101</sup> Eirik Jensen, “Permanent Establishments and Allocation Questions Pertaining to Them—Judgements of the Norway Supreme Court”, *IBFD Bulletin for International Taxation* (August/September 2002), pp. 394–395.

<sup>102</sup> CA: ITRD, Advance Income Tax Ruling, 2006-0211991.



natural resources situated in that other State for a period or periods exceeding in the aggregate 90 days in any 12-month period; or

(c) operates substantial equipment in the other State (including as provided in subparagraph (b)) for a period or periods exceeding 183 days in any 12-month period,

such activities shall be deemed to be performed through a permanent establishment that the enterprise has in that other State, unless the activities are limited to those mentioned in paragraph 6 and are, in relation to the enterprise, of a preparatory or auxiliary character.”

As mentioned, in the United Nations Model Convention, drilling rigs and ships are expressly included in the construction PE definition, insofar as these are used in exploration for natural resources for a period of longer than 12 months. Recall, however, that the construction clause can be applied to offshore exploration and drilling even if the tax treaty does not contain an express reference.

It should also be noted that the definition of royalties in Article 12 of the United Nations Model Convention includes “(...) payments of any kind received as a consideration for the use of, or the right to use (...) industrial, commercial or scientific equipment”.<sup>103</sup> Many countries include these payments in the definition of royalties in their tax treaties:

Box III.9:  
**Article 12(3)(c) of the tax treaty between Australia and Chile of 10 March 2010:**

“3. The term “royalties” in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for: (...) the use of, or the right to use, industrial, commercial or scientific equipment;”

This means that a bareboat lease of equipment, i.e. drilling rigs, vessels or other equipment, may result in the imposition of withholding

---

<sup>103</sup> Up to 1992, the definition of royalties in Article 12 of the 1977 OECD Model Convention also included the right “to use industrial, commercial or scientific equipment”; however, some countries have made reservations to maintain such taxation right.

tax under article 12 of these tax treaties if domestic legislation imposes withholding tax on such payments, as long as the activity does not constitute a PE.

### *Service and supply ships*

A number of service and supply ships operate by supporting oil and gas companies during drilling campaigns. The most prevalent are platform supply vessels (PSVs) used for transporting supplies to the rig from port facilities. Other vessels are used for towing and anchor handling, construction support, multi-purpose support, and specialized health safety and environment services, their common character being their mobility.

The issue in question is to what extent personnel and supply transportation vessels, and other auxiliary vessels, fall under the PE concept, taking into consideration that they are not geographically fixed to a place. Notwithstanding the general understanding that a moving ship would typically not constitute a fixed place, the OECD proposed in a 2012 discussion draft the addition of a new paragraph 5.5 to the Commentary on Article 5, which considers ships to be a PE:

Box III.10:

**A possible new paragraph 5.5 in the OECD Model Convention (as per 2012 discussion draft)**

“5.5 Similarly, a ship or boat that navigates within territorial waters or in inland waterways is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship or boat is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship or boat, such as a shop or restaurant, must be treated the same way.”

If a vessel operates in areas that are considered to be geographically and commercially coherent, the fixed test may be satisfied. The commercial coherence test is very ambiguous and could be interpreted in different ways. In considering this question, several factual issues — such as whether the services are done under the same contract, for identical or different clients, and invoiced under the same or different work orders or invoices — should be taken into account.

Please note that certain tax features of these services have been covered in the Drilling activity section above.

### ***Pipelines***

The Commentary on Article 5 of the United Nations Model Convention<sup>104</sup> states, when referring to cables or pipelines, that “(...) income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6”.

Apart from the fact that income derived by the owner or operator of cables or pipelines is covered by Article 6 if considered as immovable property by the domestic law of the source State, the issue is whether any exception listed in Article 5(4) related to activities of a preparatory or auxiliary nature applies and, therefore, the facilities are not considered a PE. In this respect, each case is to be considered in light of its particular circumstances. If these facilities are used to transport goods owned by third parties, then they are considered to be a PE with respect to the owner/operator of the pipeline, and neither Article 5(4)(a)<sup>105</sup> (which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility) nor Article 5(4)(e)<sup>106</sup> (since the cable or pipeline is not used solely for the enterprise and given the nature of the business) applies. If these facilities transport goods owned by the owner/operator of the pipeline, Article 5(4)(a) would be applicable if such transport is merely incidental to the business of the enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of the country solely to transport its own oil to its refinery located in another country.

As mentioned above, cables or pipelines that cross the country would be considered to be a PE if these facilities are used to transport

---

<sup>104</sup> United Nations, Department of Economic and Social Affairs, op. cit., paragraph 18 reproducing paragraph 26.1 of the OECD Model Convention.

<sup>105</sup> (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise.

<sup>106</sup> (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

property belonging to other enterprises. For the customer of the operator of the cable or pipeline (the enterprise whose product is transported from one place to another) who does not have the cable or pipeline at its disposal, the cable or pipeline cannot be considered a PE.

In a decision of the German Bundesfinanzhof (Federal Tax Court),<sup>107</sup> a Dutch company owned an underground pipeline for transporting third-party customers' crude oil and petroleum products. That pipeline was situated in the Netherlands and Germany. The Dutch company operated the pipeline remotely from the Netherlands, without having any personnel in Germany. The Court concluded that since transportation of crude oil and petroleum products was the core business of the Dutch company, the transportation activity could not be regarded as a preparatory or auxiliary activity for the purposes of determining the Dutch company's PE in Germany. As a consequence, the Dutch company was considered to have a PE in Germany in respect of the portion of the pipeline crossing German territory. In the Court's view, for a PE to exist, it was not necessary that the pipeline had to be operated by personnel belonging to the Dutch company in Germany. Even a fully automated installation could be regarded as a PE.

The German decision is relevant as it confirms that a pipeline can be considered a PE of a company whose business is to transport oil and petroleum products, even if the company has no personnel in the jurisdiction in which the pipeline is located.

### **Territorial scope of tax treaties**

Article 29<sup>108</sup> of the United Nations Vienna Convention on the Law of Treaties of 23 May 1969 establishes that “[u]nless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory”. Since many countries include the definition of “Contracting States” in Article 3 on tax treaties,<sup>109</sup> this definition determines the geographic scope

---

<sup>107</sup> Pipeline Case (No. IIR 12/92 dated 30 October 1996)

<sup>108</sup> On the territorial scope of treaties.

<sup>109</sup> Article 3 of the United Nations Model Convention is the same as Article 3 of the OECD Model Convention, except that Article 3 of the OECD Model Convention defines the terms “enterprise” and “business” in subpara-

of the application of the tax treaty. Such definition may include the notions of territory and territorial waters, which would be automatically included in the notions of State territory.

On the other hand, according to Article 77 of the United Nations Convention on the Law of the Sea (UNCLOS), coastal States may exercise “sovereign rights” for the purposes of exploration and exploitation of some of its natural resources over the continental shelf.<sup>110</sup> These rights are exclusive in the sense that if the coastal State does not explore the continental shelf or exploit its natural resources, no one may undertake these activities without the express consent of the coastal State.

Therefore, taxing jurisdiction of a State may be extended to include exclusive economic zones or the outer continental shelf if the activities are connected to exploration or exploitation of natural resources, within which the States may exercise taxing rights in accordance with international law.

In this respect, many States have extended the operation of the tax treaties into the same area outside their territory in which such States purport to extend their taxing power. Accordingly, the terms “a Contracting State” and “the other Contracting State” normally include a reference to the continental shelf, as follows:

Box III.11:

**Canada’s Section 5 of the Income Tax Conventions Interpretation Act, RSC 1985, c. I-4, as amended:**

“Canada means the territory of Canada, and includes every area **beyond the territorial seas of Canada** that, in accordance with international law

---

graphs c) and h) of paragraph 1 while Article 3 of the United Nations Model Convention does not. This is because the OECD Model Convention has deleted Article 14 (Independent Personal Services) while the United Nations Model Convention still maintains it.

<sup>110</sup> Article 76 of the United Nations Convention on the Law of the Sea (UNCLOS) defines the continental shelf as “the seabed and subsoil of the submarine areas that extend beyond its territorial sea throughout the natural prolongation of its land territory to the outer edge of the continental margin, or to a distance of 200 nautical miles [370.4 Km] from the baselines from which the breadth of the territorial sea is measured where the outer edge of the continental margin does not extend up to that distance”.

and the laws of Canada, is an area in respect of which Canada may exercise rights with respect to the seabed and subsoil and their natural resources, and the seas and airspace above every area described in paragraph (a).”

Box III.12:

**Article 3 (b) of the tax treaty between the United Kingdom of Great Britain and Northern Ireland and Russia of 15 February 1994:**

“b) The term ‘the Russian Federation’, when used in the geographical sense, means its territory, including its territorial waters as well as economic zone and **Continental Shelf** where this State exercises sovereign rights or rights and jurisdiction in conformity with international law and where its tax laws are effective.”

However, some treaties — such as old treaties signed when the development of natural resources on the continental shelf was not technologically feasible — do not expressly cover the continental shelf. Different interpretations about the application of a tax treaty can arise in such a case. It could be argued that the tax treaty applies in the same area as the domestic tax legislation of the two contracting States; the continental shelf would be covered if domestic legislation also encompasses the natural resources in the seabed. Another interpretation would be that the tax treaty only applies within the territorial area specifically referred to in the tax treaty, regardless of the domestic tax legislation.<sup>111</sup>

A case arose in Norway under the Norway-Switzerland tax treaty of 7 December 1956, which did not expressly extend to Norway’s continental shelf area. The decision of the Supreme Court of Norway<sup>112</sup> held that the tax treaty did not apply to the Norwegian continental shelf area, as was also agreed between the competent authorities of the two countries in 1982.<sup>113</sup> As a consequence, tax liability in Norway with

<sup>111</sup> Maja Stubbe Gelineck, “Permanent Establishment and the Offshore Oil and Gas Industry-Part 1”, *IBFD Bulletin for International Taxation* (April 2016), p. 209.

<sup>112</sup> *Heerema Marine Contractors SA v. Ministry of Finance*, of 9 November 1992, 122/1992.

<sup>113</sup> In an exchange of letters of 29 November and 14 December 1982.

respect to business activities carried out in the continental shelf area could be decided on the basis of Norwegian law.

Therefore, it is advisable that the issue of whether or not to include specific reference to particular geographical areas in a tax treaty should be discussed during the treaty negotiations, and if necessary addressed in the text.

***Source-state taxation: the offshore clause of other resource-rich states with a coast line***

The economic importance of the offshore petroleum industry in some coastal States resulted in a special clause in their bilateral negotiations — a clause assuming the existence of a PE if a hydrocarbon-related business activity is performed on their continental shelf. This is the case, for examples, of Norway or the United Kingdom. An example from the treaty practice of the former follows:

Box III.13:

**Article 21 (Offshore activities) of the tax treaty between Norway and South Africa of 1996:**

“The provisions of this Article shall apply notwithstanding any other provision of this Convention.

A person who is a resident of a Contracting State and carries on activities offshore in the other Contracting State in connection with the exploration or exploitation of the seabed and subsoil and their natural resources situated in that other State shall, subject to paragraphs 3 and 4 of this Article, be deemed in relation to those activities to be carrying on business in that other State through a permanent establishment or fixed base situated therein.

The provisions of paragraph 2 shall not apply where the activities are carried on for a period not exceeding 30 days in the aggregate in any period of twelve months commencing or ending in the fiscal year concerned. However, for the purposes of this paragraph, activities carried on by an enterprise associated with another enterprise, within the meaning of Article 9, shall be regarded as carried on by the enterprise with which it is associated if the activities in question are substantially the same as those carried on by the last-mentioned enterprise, except to the extent that those activities are carried on at the same time.

Profits derived by a resident of a Contracting State from the transportation of supplies or personnel to a location, or between locations, where activities in connection with the exploration or exploitation of the seabed and subsoil and their natural resources are being carried on in a Contracting State, or from the operation of tugboats and other vessels auxiliary to such activities, shall be taxable only in the Contracting State of which the enterprise is a resident.”

This alternative implies that several of the traditional features of basic PE are removed. In particular, under the offshore clause neither a “fixed place of business” nor a “right of use test” or a “business connection test” seem necessary to constitute a PE. In this respect, the offshore clause does not require a specific geographical location within this area, the test being whether or not the activities are to be performed within the overall offshore area.

## **The “geographical and commercial coherence” test**

### ***More than one PE***

As previously noted, the “geographical and commercial coherence test” provides that, in principle, any geographical area that commercially or economically constitutes a unit may be considered as a fixed place of business for PE purposes.

From the perspective of an oil and gas company, legal title by means of a petroleum contract in the form of a concession or a Production Sharing Contract is granted over a contractual area (geographic element) which is normally governed by several partners under a JOA, one of them being designated the operator. Therefore, from a factual point of view, each contractual area (geographical element) is independently managed through a consortium (commercial element). Accordingly, when an oil and gas company has entitlements to more than one contractual area in a country, it would normally be considered that it has more than one PE within that country.

This result is supported by many factors involving the oil and gas structure. As mentioned above, E&P activities in a country are normally established by signing a single contract per geographical area with the corresponding governmental authority. Each geographical



area is subject to exploitation, usually separated and isolated from each other. Sometimes they contain different kinds of hydrocarbons (oil or gas) or involve different partners associated in different joint ventures or associations which are governed by different JOAs. Frequently, separate petroleum contracts have different legal and tax regimes, depending on the date signed, as certain tax stability clauses may apply.

It should also be noted that each joint venture, consortium or association has its own financial accounts, independent from those formed in other areas. Therefore, each contractual area is managed independently from one another, each having its own operating management. Each joint venture, consortium or association normally files income tax returns on behalf of its participants to whom they then attribute the revenue and the taxes paid.

In addition, many countries have established “ring-fence” regulations, which disallow offsetting losses from one field against profits of another. Even in countries that permit consolidation of losses between contract areas, as long as the separate contract areas are distinct in the other ways noted above, each contractual area will nevertheless usually be considered a separate PE.

While the E&P blocks are located in specific areas, being defined by the concession or petroleum contract signed for each of them, the office is normally established in the main city of the country, which could be far away from the mentioned blocks. Following the example provided in the Commentary on Article 5 of the United Nations Model Convention<sup>114</sup> regarding a consultant performing similar activities as part of the same project to distinct branches, it may also be argued that the office constitutes a separate PE from the blocks due to lack of geographical coherence.

Commercial coherence takes several indicators into consideration, such as the contract, the client, the time factor, the functions performed and the participants in the project. All of these factors should be analysed on a case-by-case basis. A decisive factor for treating different operations as one project is when one contract has been concluded. In the case of oil and gas companies, since blocks

---

<sup>114</sup> United Nations Model Convention Commentary on Article 5, paragraph 3, reproducing paragraph 5(4) of the OECD Model Convention Commentary.

are generally managed through different JOAs, each block is normally considered as an independent commercial unit.

The Commentary on Article 5 of the OECD Model Convention<sup>115</sup> (the United Nations Model Convention does not adopt this aspect of the OECD Commentary) contains some additional criteria for establishing the commercial coherence of “connected projects” within the alternative services PE rule, which could also be considered to be relevant in addressing the commercial coherence or fixed place of business under Article 5(1). This Commentary states that the reference to “connected projects” is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects have a commercial coherence. The determination of whether projects are connected will depend on the facts and circumstances of each case, but factors that would generally be relevant for that purpose include

- Whether the projects are covered by a single master contract;
- Where the projects are covered by different contracts, whether these different contracts were concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;
- Whether the nature of the work involved under the different projects is the same; and
- Whether the same individuals are performing the services under the different projects.

### *Splitting up of contracts*

The six-month test established under Article 5(3) of the United Nations Model Convention applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically.<sup>116</sup>

---

<sup>115</sup> OECD, op. cit., para. 42.41 of the Commentary on Article 5.

<sup>116</sup> United Nations Model Convention Commentary on Article 5, paragraph 11, reproducing paragraph 18 of the OECD Model Convention Commentary.

However, as mentioned above under the Drilling activity section, the six-month threshold has given rise to abuses as it has been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period of less than six months and attributed to a different company, which was, however, owned by the same group.

In this respect, the United Nations Model Convention Commentary observes that: “[a]part from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations”.

In a similar way, OECD BEPS Action 7 specifically addresses the splitting up of construction contracts between group companies into shorter periods of time in order to benefit from the “construction site” exemption. The OECD sets out that the splitting should be prevented by applying the principal purposes test, proposed as part of Action 6 on the prevention of treaty abuse, or by a specific provision which aggregates the activities of closely related enterprises on the same site during different periods of time (each exceeding 30 days) for the purpose of determining the 12-month period. The proposed provisions read as follows:

Box III.14:

**Paragraphs 52-53 of the OECD Commentary on paragraph 3 of Article 5 replaced by BEPS Action 7**

“For the sole purpose of determining whether the twelve-month period referred to in paragraph 3 has been exceeded,

- a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during periods of time that do not last more than twelve months, and
- b) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,

these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.

The concept of “closely related enterprises” that is used in the above provision is defined in subparagraph b) of paragraph 6 of the Article (see paragraphs 119 to 121 below).

53. For the purposes of the alternative provision found in paragraph 52, the determination of whether activities are connected will depend on the facts and circumstances of each case. Factors that may especially be relevant for that purpose include:

- whether the contracts covering the different activities were concluded with the same person or related persons;
- whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;
- whether the activities would have been covered by a single contract absent tax planning considerations;
- whether the nature of the work involved under the different contracts is the same or similar; or
- whether the same employees are performing the activities under the different contracts.”

The E&P blocks are where the actual E&P activities are performed, and each block is generally governed under distinct petroleum contracts assigned to joint ventures with different partners governed under a JOA, while the office as a coordination centre provides administrative and technical support, and supervisory activities to each of the blocks in which the company has a participation. Therefore, the E&P blocks and the office are considered to carry on different activities, which cannot be regarded as a single project.

With respect to subcontractors, the individual circumstances of each case have to be considered, since having signed different contracts with different clients—as long as no abusive elements are found—should not lead to an aggregation of the projects into a single project with regard to the calculation of the timing threshold established in the tax treaty.

## The attribution of profits to a PE

Once a PE is deemed to exist in the source country, its mere existence does not, by itself, mean that additional taxes are owed to the country where the PE is located. The 2008 OECD Report on the Attribution of Income to Permanent Establishments adopts a “functionally separate entity” approach, where the PE is treated as an entity distinct from its overseas parent for several purposes.

However, the United Nations Tax Committee decided at its 2009 annual session to not adopt the OECD approach to Article 7 arising from the OECD 2008 report. The 2008 OECD Report envisions dealings between different parts of an enterprise (such as a PE and its head office) to a greater extent than is recognized by the United Nations Model Convention. The United Nations Tax Committee decided not to adopt this OECD approach because it was in direct conflict with paragraph 3 of Article 7 of the United Nations Model Convention, which generally disallows deductions for amounts “paid” (other than towards reimbursement of actual expenses) by a PE to its head office. That rule is seen as continuing to be appropriate in the context of the United Nations Model Convention, whatever changes have been made to the OECD Model Convention and Commentary. It should also be noted that only a few countries have implemented the “functionally separate entity” approach and many others have made their outright reservation and will not apply the rule.

## Services PE

In the 2008 proposal for amendments of the United Nations Model Convention, the United Nations Tax Committee already recognized the difficulties in combining Article 14 and Articles 5 and 7<sup>117</sup> and decided

---

<sup>117</sup>United Nations Economic and Social Council Committee of Experts on International Cooperation in Tax Matters, E/C.18/2008/CRP.4. Available at [http://www.un.org/esa/ffd/tax/thirdsession/EC18\\_2007\\_CRP4.pdf](http://www.un.org/esa/ffd/tax/thirdsession/EC18_2007_CRP4.pdf). After considering the arguments for and against deletion of Article 14, the subcommittee concluded that retaining the combination of Article 14 and Articles 5 and 7 would continue to cause difficulties, ambiguities and uncertainty in the application that benefit neither administrations nor taxpayers. These difficulties include the uncertainties over the personal scope of Article 14, the scope of activities that fall under Article 14, the possible

to retain Article 14, although an alternative provision was introduced in the Commentary for States that wished to remove Article 14:

Box III.15:

**United Nations Model Convention alternative text for countries deleting Article 14**

“15.5 Article 14 would be deleted. Subparagraph (b) of paragraph 3 of Article 5 would read as follows:

(b) the furnishing of services by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned;

15.6 The changes to the version of this subparagraph in the 1999 United Nations Model Convention are minor, comprising (i) the deletion of the words “including consultancy services,” after the words “the furnishing of services,” on the basis that the wording was unnecessary and confusing, such services being clearly covered; (ii) the replacement of the six-month test with the 183 days test, (...); and (iii) the use of a semicolon rather than a period at the end of the subparagraph, with the introduction of subparagraph (c). In relation to the wording of subparagraph (b) some members of the Committee consider, however, that the words “(for the same or a connected project)” should be eliminated as no such requirement exists in Article 14.

15.7 A new subparagraph (c) of paragraph 3 would also be inserted, as follows:

(c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual’s stay in that State is for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned.

Subparagraph (c) is intended to ensure that any situation previously covered by Article 14 would now be addressed by Articles 5 and 7. The wording reflects the fact that deletion of Article 14 of the United Nations

---

interpretation of a difference between the concepts of PE and fixed base, difficulties over the taxation of partnerships under Article 14 (especially when of a mixed individual/company character) and in relation to the taxation of large worldwide partnerships of lawyers.

Model Convention would involve deletion of the “days of physical presence” test found in subparagraph (b) of paragraph 1 of Article 14 of that Model, which had no counterpart in the OECD Model Convention when the deletion of Article 14 was agreed for that Model.”

In accordance with paragraph 3(b) of Article 5 of the United Nations Model Convention, the furnishing of services, including consultancy services, through employees or other personnel of an enterprise of one Contracting State, constitutes a PE in the State where such services are performed if the activities for the same and connected project continue there for a period or periods aggregating more than 183 days within any 12-month period. The United Nations Model Convention goes beyond the fixed base concept, since under the rule, the mere furnishing of services as such already leads to the taxation of the enterprise by the source State, even if the enterprise has no fixed base in that State. This extension of taxation by the source State is of particular significance in connection with making personnel available and with providing technical assistance; under the United Nations Model Convention, and contrary to the situation under the OECD Model Convention, both activities would result in taxation by the State benefiting from the services.<sup>118</sup>

In this case, the requirements of Article 5(1) of the United Nations Model Convention, described above in the section on the basic rule of permanent establishments, do not have to be fulfilled. This provision is of particular significance in connection with making personnel available in respect of certain services or activities not covered by Article 5(3)(a) of the United Nations Model Convention (e.g., technical assistance or repair services) explained above in the construction work clause section.

In addition, it should also be noted that Contracting States may evaluate assimilate fees for technical services as royalties under Article 12 of the United Nations Model Convention or under the new “fees for technical services” provision, described below in the section on fees for technical services, rather than assuming the existence of a PE. In such

---

<sup>118</sup>Ekkehart Reimer and Alexander Rust (Eds.). *Klaus Vogel on Double Taxation Conventions* (New York: Wolters Kluwer 2015), pp. 310–311.

a case, the source taxation will apply a withholding tax irrespective of the duration of the services.

In 2000, Article 14, related to “Independent Personal Services”, was deleted from the OECD Model Convention as it was concluded that there was no practical difference between Articles 7 and 14 or, where such differences existed, there did not appear to be any valid policy justification for them.<sup>119</sup>

However, in 2008, the OECD included a service PE alternative provision to Article 5 in the Commentary for States that believe that additional source taxation rights should be allocated under a treaty with respect to services performed in their territory.<sup>120</sup> The OECD included the provision in the Commentary and not in the Model Convention articles because the Committee identified a number of compliance and double-taxation issues associated with the provision, which are explained in the Commentary.<sup>121</sup>

### **Fees for technical services**

Due to the difficulties in dealing with the concept of PE in relation to technical services, and the issue of base erosion in developing countries, a new Article (Article 12A) was added to the 2017 United Nations Model Convention to allow a Contracting State to tax fees for certain technical and other services made to a resident of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States.

Until the addition of Article 12A, income from any service of a managerial, technical or consultancy nature derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was a resident. However, if the enterprise carried on business through a PE in the other State (the source State) or provided professional or independent personal services through a fixed base in

---

<sup>119</sup> OECD, Issues Related to Article 14 of the OECD Model Convention. 1 April 2000.

<sup>120</sup> OECD Model Convention Commentary on Article 5, op. cit., paragraph 42.43 (Alternative service provision).

<sup>121</sup> OECD, Model Convention Commentary on Article 5, op. cit., paragraph 42.12.



the source State, the source State was entitled to tax the income attributable to the PE or fixed base under Article 7 or 14 respectively. In the absence of a PE or fixed base in the source State, it was thought that an enterprise resident in a Contracting State was not sufficiently involved in the economy of the source State to justify that State taxing the income. However, with the rapid changes in modern economies, particularly with respect to cross-border services, it is now considered possible for an enterprise resident in one State to be substantially involved in another State's economy without a PE or fixed base in that State and without any substantial physical presence in that State.

Box III.16:

**Agreed text for new Article 12A of the United Nations Model Convention**

**“Fees for Technical Services**

Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

However, notwithstanding the provisions of Article 14 and subject to the provisions of

Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed \_\_\_ per cent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term “fees for technical services” as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made

- to an employee of the person making the payment;
- for teaching in an educational institution or for teaching by an educational institution; or
- by an individual for services for the personal use of an individual.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent

personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with

- such permanent establishment or fixed base, or
- business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees—whether that person is a resident of a Contracting State or not—has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.

6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State or the third State, or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.

7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.”

Article 12A allows fees for technical services to be taxed by a Contracting State on a gross basis. Many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from services derived by non-residents. A withholding tax imposed on the gross amount of payments made by residents of a country, or non-residents with a permanent establishment or fixed base in the country, is well established as an effective method of collecting tax imposed on non-residents. Such a method of taxation may also simplify compliance

for enterprises providing services in another State since they would not be required to compute their net profits or file tax returns.<sup>122</sup> In this respect, the Commentary observes that:

“A precise level of withholding tax on fees for technical services should take into account several factors, including the following:

- the possibility that a high rate of withholding tax imposed by a country might cause non-resident service providers to pass on the cost of the tax to customers in the country, which would mean that the country would increase its revenue at the expense of its own residents rather than the non-resident service providers;
- the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment;
- the possibility that some non-resident service providers may incur high costs in providing technical services, so that a high rate of withholding tax on the gross fees may result in an excessive effective tax rate on the net income derived from the services;
- the potential benefit of applying the same rate of withholding tax to both royalties under Article 12 and fees for technical services under Article 12A(...).
- the fact that a reduction of the withholding rate has revenue and foreign-exchange consequences for the country imposing withholding tax; and
- the relative flows of fees for technical services (e.g., from developing to developed countries).”

Alternatively, countries, which wish to obtain additional taxing rights on fees for technical services, but are concerned with the broad scope of Article 12A, may consider agreeing to amend Article 12 (Royalties) to permit taxation of certain “fees for included services” an approach that is found in a number of bilateral tax treaties between developing and developed countries.

---

<sup>122</sup>United Nations Model Convention Commentary on Article 12A, paragraph 28.

## Examples of tax treaties that include technical fees

Box III.17:

### **Italy-Viet Nam Income Tax Treaty of 26 November 1996**

#### **Article 12**

##### **“Royalties and fees for technical services**

Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the recipient is the beneficial owner of the royalties or of fees for technical services, the tax so charged shall not exceed

in the case of royalties, 10 per cent of the gross amount of such royalties; in the case of fees for technical services, 7.5 per cent of the gross amount of such fees.

3. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

4. The term “fees for technical services” as used in this Article means payments of any kind to any person, other than payments to an employee of the person making the payment, in consideration for any services of a managerial, technical or consultancy nature rendered in the Contracting State of which the payer is a resident. (...)”

### **Papua New Guinea-United Kingdom Income Tax Treaty of 17 September 1991**

#### **Article 14**

##### **“Technical fees**

Technical fees arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

However, such technical fees may also be taxed in the Contracting State in which they arise and according to the law of that State, but if the recipient is the beneficial owner of the technical fees the tax so charged shall not

exceed 10 per cent of the gross amount of the technical fees.

The term “technical fees” as used in this Article means payments of any kind to any person, other than an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature. (...)”

### For more information

- Arvid A. Skaar. “Permanent Establishment. Erosion of a Tax Treaty Principle” in *Series on International Taxation*. (Wolters Kluwer Law and Taxation Publishers, Deventer, Boston, 1991).
- Brian J. Arnold. “Threshold requirements for taxing business profits” in *The taxation of business profits under tax treaties*. (Canadian Tax Foundation, 2003).
- Jan de Goede and Ruxandra Vlasceanu. *Permanent Establishment Implications for Coordination Centres in the Oil and Gas Industry*. (IBFD Bulletin for International Taxation, September 2013).
- Eirik Jensen, Supreme Court Barrister, *Permanent Establishments and Allocation Questions Pertaining to Them—Judgements of the Norway Supreme Court*. (IBFD Bulletin for International Taxation, August/September 2002).
- Maja Stubbe Gelineck. *Permanent Establishment and the Offshore Oil and Gas Industry—Part 1 and 2*. (IBFD Bulletin for International Taxation, 2016).
- Arvid A. Skaar, Jacques Sasseville (Eds.), *Is There a Permanent Establishment?*, (IFA Cahiers de Droit Fiscal International, 2009).
- Bart Koster and Roberto Bernales: *Oil and Gas Operational Structure Based on Joint Operation Agreements Gives Rise to Multiple Permanent Establishments within a Single Country*. *European Taxation*, September 2015 (Volume 55) No. 10.
- United Nations, Department of Economic and Social Affairs (2011). *2011 United Nations Model Taxation Convention between Developed and Developing Countries*. Available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).
- United Nations, Department of Economic and Social Affairs (2018). *2017 United Nations Model Taxation Convention between Developed and Developing Countries*. Available at <http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html>



## Chapter 4

### INDIRECT TRANSFER OF ASSETS

#### Executive summary

The issue of indirect transfers of assets in mining and oil and gas, as well as in other sectors, is receiving increasing attention, particularly in developing countries. The concern often expressed is that by using the principle of separate legal personality, and tax planning through residence of companies and similar entities, multinational enterprises (MNEs) may, in substance, change the ownership of an asset located in a developing country without triggering the corresponding taxation of the economic profits from the ownership change in that developing country. What is often said to amount “in substance” to the sale of an asset in the developing country (which may otherwise attract tax on the profits) is transformed into an offshore sale of a foreign holding company (which may hold the developing-country asset directly or through other foreign companies) usually to an offshore buyer. The claim is then usually made that the developing country lacks the jurisdiction under the domestic law to tax such an “extraterritorial” event not involving its own tax residents and not directly involving assets in that country. The further claim is often made that even if domestic law allowed taxation on indirect transfer of assets, a tax treaty between the developing country and the country of the transferor company overrides any domestic taxing right the developing country might otherwise have had.

In examining the issues involved in the taxation of indirect transfers, the first consideration should be the basic policy issue of whether the country should tax gains made on the *direct* transfer of capital assets at the time of the transfer or should only tax the profits over time as income is generated by those assets. Therefore, this chapter first examines the issues involving the taxation of capital gains in the area of extractives, including its pros and cons. If the policy decision is to tax such gains on the direct transfer of assets, a further policy decision is whether the country desires also to tax the *indirect* transfer of capital assets. If a country determines, as a general policy matter, to tax indirect transfers, it must also decide on the types of transfers it wishes to tax. For example, certain business reorganizations

are often exempt from immediate taxation, even if done directly and within the country. Some transfers of smaller shareholdings are similarly exempted. This chapter will therefore consider factors in deciding whether immediate tax should be imposed on certain transfers in the extractive industries, whether indirect or direct.

Where a country determines that immediate taxation should be imposed on a particular indirect transfer, the final set of issues relates to how this should be done, given that the transferor and the transferee are often foreign tax residents and the transaction is conducted outside the country where the assets are located. From a policy and administration viewpoint, the issues involved include:

- (i) How to ensure an awareness of such transactions when they occur, by taxpayers and administrations;
- (ii) Who should bear the tax obligation;
- (iii) How a system of taxing indirect transfers can be achieved fairly but with a degree of certainty that tax will be paid; and
- (iv) How applicable tax treaties impact the taxing rights over such transfers. In other words, how a tax treaty may interact with either general or specific provisions in domestic law seeking to address perceived abuses in this area, including the issue of “treaty override” rules, also needs to be considered.

This chapter gives examples of responses to this issue and practical guidance on other potential responses.

## **Purpose**

This chapter is intended to provide options for policymakers and administrators in developing countries on the taxation of indirect transfer of assets within the extractive industries, as well as to offer guidance on the pros and cons of such options which are specific to this type of industry. It also seeks to assist countries in limiting potential negative aspects of options taken.

More specifically, the chapter explores the issues involved in deciding whether a tax should apply to capital gains in the extractive industries and, if so, under what circumstances. In cases where there is such a tax, it further explores some of the policy and administration



issues involved in covering indirect transfers, whereby extractive assets are not themselves transferred (as in figure I below) but companies or other entities (often resident offshore) holding the assets directly or through further entities are transferred (as in the simple example in figure II).

An issue of concern is that the indirect transfer of assets may be motivated by—and the structured primarily around—avoiding capital gains tax by having the transfer occur at the level of a company in a low or no-tax jurisdiction, rather than in a country where the extractive assets are located. On the other hand, there can be circumstances where such indirect transfers are effectively and genuinely motivated by other non-tax business considerations, such as in large merger transactions, or in situations where parties are trying to maintain other corporate attributes that stem from the manners in which assets are directly owned. While such non-tax reasons need to be fairly recognized and taken into account, they should not be used to disguise or give a cover for tax-motivated structuring, of course; the realities of the situation as a whole have to be evaluated. As this chapter shows, taxing indirect transfers can raise difficult issues which may be relevant to policy decisions regarding whether the transfers are taxed at all and, if they are, how that is achieved.

In essence, the issues are (i) whether gains from direct transfers of extractive assets should be taxed; (ii) whether gains from *indirect* transfers of the same extractive assets should be treated (by the country where the mine or other extractive assets are located) in the same way as in a direct transfer of extractive assets; and (iii) if so, how tax on such a gain can be effectively implemented from the perspectives of administrations and taxpayers. It is recognized that, as background to this issue, there are differences between common law and civil law legal systems that should be borne in mind. It has been noted that:

[T]he essence of the difference is that civil law countries treat all the income of a commercial company as business profits; the result is that the approach in the case of income earned by a commercial company is based on the type of person, while common law countries make the determination according to the type of income. The most obvious example of this difference in approach is that common law countries make a distinction between capital gains and business profits when taxing

companies; civil law countries do not, because capital gains are part of business profits.<sup>123</sup>

The term “transfer,” whether direct or indirect, is used for convenience in this chapter, and is intended to cover not just sales where money changes hands, but also many other forms of changes in ownership interests relating to extractive assets, e.g., swaps (including asset-for-share transactions) and farm-in sale price to treatment under the developing country’s tax arrangements of the type discussed below in this Chapter.<sup>124</sup> Similarly, the reference to extractive “assets” refers not just to physical assets, but also to the rights appertaining to their use, such as exploration and development rights; some countries specifically provide for information relating to extraction (such as survey information) to be treated in the same way, because of the value it may have, and the role it plays in the pricing of a transfer.

A particular issue for many policymakers and administrators is how a policy decision to tax indirect transfers of valuable extractive industries interests can be effectively implemented in practice. Implementing such a regime involves information and administrative (including enforcement) considerations and requirements for tax authorities. For sellers/transfersors, it raises issues of their liability to taxation in a country that is neither their country of residence nor where a transfer occurred. It also raises issues of whether a seller will be taxed by a country, but the buyer will not be entitled to the treatment under the same country’s tax law that the buyer would be accorded in the case of a *direct* transfer of the asset (i.e., where the tax basis of the asset in the hands of the buyer equals its purchase price), even though the tax situation of the seller is likely to be factored into the sale price.

There are particular issues for taxpayers and administrations when the indirect transfer or sale concerns a small percentage of an asset, or when an asset is sold to multiple buyers. Keeping track of changes

---

<sup>123</sup> John F. Avery Jones and others, “Treaty Conflicts in Categorizing Income as Business Profits: Differences in Approach Between Common Law and Civil Law Countries”, in *Bulletin for International Fiscal Documentation* (June 2003), pp. 237–248, including footnotes 4 and 5.

<sup>124</sup> See also the discussion in Jack Calder, *Administering Fiscal Regimes for Extractive Industries: a Handbook* (Washington, D.C., International Monetary Fund, 2014), p.87.

in the indirect ownership of assets imposes an increased burden on tax administrations and can be constrained by its ability to collect and compile information. In this sense, the more capable the information technology systems of an administration are; the more effective its information-gathering powers are; and the more integrated into the international system of exchange of taxpayer information it is, the easier it will be to account for and tax indirect transfer of assets.

A transfer to a single entity raises fewer complexities, but the same policy considerations apply. If a country determines to tax such indirect transfers, it is particularly important for the source country's domestic legislation to explicitly address the indirect transfer as one that is subject to tax. Provided the seller and buyer both know that the transfer will be subject to a capital gains tax, they can take the tax into account upon sale of the asset and may be able to adjust the price or other contract terms to account for the taxes which will be due in the source state, either by a fixed amount or by reference to some formula based on tax ultimately imposed. In some cases, up front taxation of indirect transfers may preclude a transfer taking place, given that the economics of the transaction will be different from ones where the indirect transfer is not a taxable event.

Annex I to this chapter shows a “decision tree” of major policy decisions that arise in this area, with an indication of where each of the issues is discussed in this paper. Annex II deals with some symmetry issues that often arise in indirect transfer cases.

## The issues

### *Should capital gains be taxed?*

A threshold policy issue is whether to tax gains made when an asset is disposed of *directly*, such as by sale or other transfer. Such a tax is referred to as a capital gains tax (CGT) in this chapter, although in some countries such gains are subject to a distinct capital gains tax (whether comprehensive<sup>125</sup> or more specific) while in others the gain will be taxed under the general income tax provisions, or as a capital

---

<sup>125</sup> In practice, no capital gains tax (CGT) is completely comprehensive. The term is used here to mean a relatively comprehensive system of taxation of capital gains.

gain specifically brought under those income tax provisions, rather than as a separate tax on capital items only.

In a CGT, what is taxed is the *gain* made from the disposal, not the full amount received as proceeds. For a CGT to operate in a particular case, the *person* making the gain will have to be subject to the tax; the *type of asset* disposed of and the *type of disposition* will have to be covered by the tax; and the *type of gain* made will have to be of a type covered by the tax.

Figure IV.1:  
**Direct transfer**

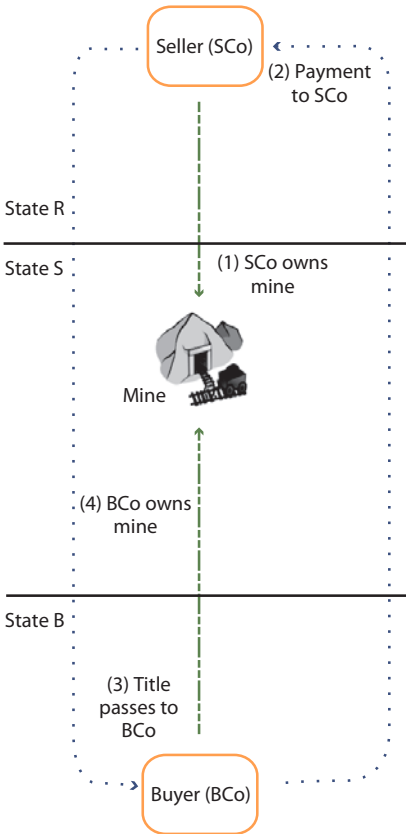
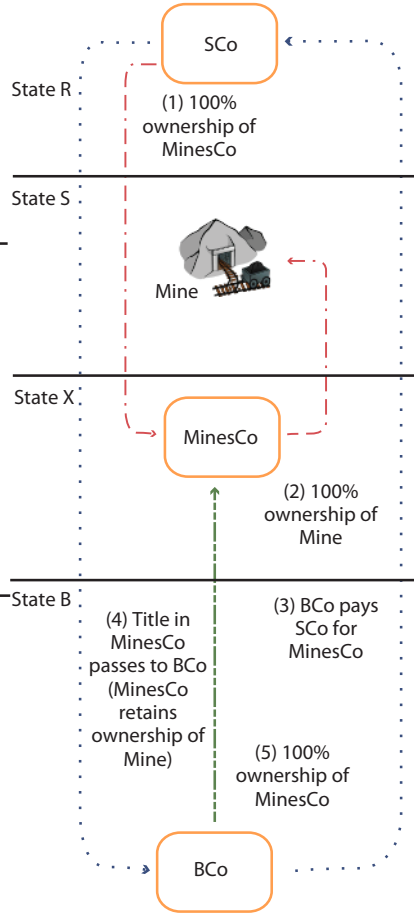


Figure IV.2:  
**One form of indirect transfer**



Policy reasons for or against taxing capital gains comprehensively will inevitably include reasons related in practice to passive assets rather than active assets. While some of these reasons may not be relevant to the extractive sector assets, they are helpful in understanding the wider issues when deciding whether or not a comprehensive tax on capital gains should be introduced. Assuming a capital gain tax is introduced, the reasons assist in assessing whether in the case of certain active assets there should be an exception.

### *Arguments for taxing capital gains*

In policy terms, there are many reasons why capital gains might be taxed, and not all of them will be directly relevant to transfers of extractive assets or even other corporate assets. Reasons commonly given for taxing capital gains when realized include the following:

- (i) The need for base broadening, as part of a trend to widen tax bases and lower tax rates among many countries. The benefits from ownership of property and other forms of capital may not otherwise be as comprehensively taxed as income and consumption, and expanding the tax base in this direction may also have lower economic costs than a rise in tax rates on income items;<sup>126</sup>
- (ii) The concern that if there is no CGT (or even taxation at a lower rate) taxpayers would rather acquire assets generating capital gains because of the difference in tax treatment between ordinary income and capital gains, thus distorting economic decisions. This leads to a lack of “horizontal equity” between two persons earning the same amounts, one through a capital gain and one through ordinary income, such as wages or business profits. A CGT may reduce the incentive to invest in those assets most likely to produce capital gains.<sup>127</sup> Without CGT, there is a lack of neutrality in the system that prefers capital returns over

---

<sup>126</sup> Victoria University of Wellington, *A Tax System for New Zealand’s Future, Report of the Victoria University of Wellington Tax Working Group: New Zealand Tax Working Group Report* (2010), p. 16. Available at <http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf>.

<sup>127</sup> *Ibid*, p. 63.

normal income and creates incentives towards conversion (or the appearance of conversion) of normal income into capital gains. Horizontal equity requires that individuals in similar economic circumstances should bear a similar tax burden irrespective of the form the accretion of the economic benefit takes. In other words, taxpayers should bear similar tax burdens, irrespective of whether their income is received in the form of wages or capital gain. The exclusion of capital gains from the income tax base fundamentally undermines the horizontal equity of the tax system;

- (iii) The concessionary treatment of capital gains as compared to income gains can also lead to speculation and inflation of preferred classes of investments (such as the housing sector). This leads to inefficient allocation of resources, as well as the waste of human capital in recharacterizing income as capital gains and in combatting such attempts. The application of scarce resources to tax planning and tax avoidance is a dead-weight loss to society;
- (iv) The wealthiest persons (including corporates) will be most likely to make significant capital gains. To tax capital gains reflects their greater ability to pay tax and addresses the conversion of income into capital. Not taxing capital gains results in a lack of horizontal equity that arises because one taxpayer is likely to have proportionately more capital returns, while the other earning the same amount is likely to rely more on normal income. Vertical equity requires that taxpayers with greater ability to pay taxes should bear a greater burden of taxation. It is commonly accepted that capital gains accrue disproportionately to wealthier individuals. Thus, including capital gains in taxable income contributes to the progressivity of the income tax system, while enabling government to pursue other tax policy objectives, premised on widening tax bases and reducing standard tax rates;<sup>128</sup>

---

<sup>128</sup> See also Thomas L. Hungerford, “The Economic Effects of Capital Gains Taxation”, in *Congressional Research Service* (June 2010). Available at <https://fas.org/sgp/crs/misc/R40411.pdf>.

- (v) A comprehensive CGT represents a “safety net” that taxes economic gains that would avoid taxation as normal income. It thus implements a more comprehensive concept of taxable “income” than might apply on normal concepts, such as in case law. In some countries, the law might in fact already reflect this more comprehensive approach to “income tax”; and
- (vi) Taxing such gains will speed up the point when tax is paid to the location where the asset is utilized.

### ***Arguments against taxing capital gains***

Reasons commonly given for not taxing such gains include the following:

- (i) A tax on capital gains inappropriately taxes illusory income, since a large component of any gain is due to inflation on assets held over many years;
- (ii) Not taxing capital gains may encourage investments by allowing them to occur at a lower economic cost, which in turns creates jobs and encourages economic growth;
- (iii) A comprehensive CGT may be difficult to administer. The potential exceptions, investment distortions and other efficiency implications that may arise from a partial CGT are economically harmful;
- (iv) The complexity (including difficulties in identifying all possible disposal events) of many comprehensive CGT regimes, especially for developing countries, comes with high administration costs (for the revenue administration) and compliance costs (for taxpayers).<sup>129</sup> One senior US Senator stated in 2012 that “...we must consider complexity. Experts tell us that about half the US tax code—more than 20,000 pages—exists solely to deal with capital gains...”;<sup>130</sup>

---

<sup>129</sup> See, for example, J. Clements, C. Lammam and M. Lo, “The Economic Costs of Capital Gains Taxes in Canada”, in *Capital Gains Tax Reform in Canada: Lessons from Abroad* (Canada, Fraser Institute, 2014), p.10. Available at <https://www.fraserinstitute.org/sites/default/files/economic-costs-of-capital-gains-taxes-in-canada-chpt.pdf>.

<sup>130</sup> US Senate Finance Committee Chairman Max Baucus (2012). Available at <http://crfb.org/blogs/capital-gains-and-tax-reform>.

- (v) Taxing business-related capital gains is purely a timing issue. If gains are taxed, the purchaser obtains a step up in basis for the acquired assets equal to the price paid, which provides a tax deduction over time against the purchaser's future income. If the gain is not taxed, no such increased tax basis arises and future income and taxes due are higher. The overall tax paid over time is the same. Given this, and specifically with respect to indirect transfers, the benefits of seeking to tax gains is outweighed by the costs and complexities in doing so, as explained further in this chapter;
- (vi) The deductibility of the stepped-up asset basis referred to in "v" above is an issue of particular relevance to taxpayers and one of the main justifications for countries not imposing a CGT on indirect transfers (when the seller might not have the opportunity to further deduct it from his income tax return upon sale of a business or an asset). That is particularly true for those countries concerned with their ability to attract foreign direct investment. In order to make sure the (direct or indirect) transfer is addressed appropriately by the CGT legislation, and the taxpayer is allowed a deduction for the cost incurred, policymakers can adopt approaches such as:
- Taxing the consideration received by the transfer, reduced by the undeducted cost of the transferred right and allowing the acquirer to deduct (over time) the consideration paid for the right (i.e., a stepped-up basis approach); or
  - Not taxing the consideration received by the transfer, reduced by the undeducted cost of the transferred right, but likewise not allowing the acquirer to deduct the consideration paid for the right and instead only allowing future deductions equal to the transferor's undeducted costs of the right (i.e., a carryover basis approach).
- (vii) Capital gains taxes are in a sense "voluntary" taxes, unlike taxes on ordinary income. Only when a taxpayer chooses to dispose of assets may tax be payable in respect of those assets. Economic decisions as to disposal of assets will therefore be influenced and potentially distorted by such



a tax. This arises since there will be an incentive to retain some investments, even if more profitable or productive opportunities exist, with the result that the economy loses the extra output that would have resulted from the reallocation of capital occurring in the absence of the CGT. This is the so-called lock-in effect of a capital gains tax.<sup>131</sup> It follows that, for some, not taxing such gains prevents encouraging these sorts of economic distortions;

- (viii) Not taxing capital gains can keep a country competitive with other countries that do not tax such gains, and create a competitive advantage over those that do; and
- (ix) Economic double taxation arises if capital gains on the sale of shares and other interests in entities directly or indirectly owning business assets are taxed. The value of the shares and other interests reflects expected future profits of the extractive activities and the future profits will be taxed as they arise. That would also be the case if the business assets consist of extractive licences, or other extractive assets. Said differently, taxes on gains from sales of investment assets are in effect a double tax; the income earned to make the investment was already subject to an income tax and the income from further use of the asset will also be taxed even in the absence of a capital gains tax.

***If capital gains are taxed, what should be taxed and how should that be done?***

A country's domestic tax laws could tax capital gains through:

- (i) **Stand-alone CGT on the gain made through the transfer.** The CGT could be a comprehensive CGT where the disposal of any kind of assets would be subject to taxation. Alternatively, a specific CGT could be configured, aiming to tax only certain assets or transactions. A comprehensive

---

<sup>131</sup> See, for example, J. Clements, C. Lamman and M. Lo, "The Economic Costs of Capital Gains Taxes in Canada", in *Capital Gains Tax Reform in Canada: Lessons from Abroad* (Canada, Fraser Institute, 2014), p.10. Available at <https://www.fraserinstitute.org/sites/default/files/economic-costs-of-capital-gains-taxes-in-canada-chpt.pdf>.

CGT could have exemptions or “rollovers” delaying the timing of taxation for certain types of assets or upon certain types of events. Such exceptions can distort economic decisions in favour of certain types of assets, but a country may regard that as appropriate to encourage investment in that area.

Taxing certain transactions where no cash or other readily marketable property is involved can be harmful to efficient and cost-effective corporate repositioning of assets. In such cases, a country might consider it appropriate, as a means of not discouraging economically beneficial transactions, to exempt or defer tax, where such relief is not seen as abusive of the CGT system. The benefits may be that businesses will be more efficient, and profitable, and therefore able to generate more value over time (including creating additional jobs and additional tax revenues). For example, certain reorganizations between related parties are often exempt, or tax is deferred until there is a disposal to an unrelated party. Even if such an approach is taken, in some cases it may only apply where the restructuring will not lead to reduced tax liability at a later stage.

With respect to the extractive industries, it would in practice be very rare for a tax system to exempt all gains from the sale or other transfer of assets used in resource extraction, particularly the exploration and extraction rights and the extractive facilities, from the operation of CGT. However, rules that apply to other businesses, and tax principles that apply to reorganizations or the facilitation of efficient investment, are also highly relevant and important to resource extraction. This issue is specifically considered below in the context of indirect transfers.

If there are different tax rates between capital gains and ordinary income, or if the rules operate differently as between the two, there will be clear incentives to attempt to earn capital gains rather than ordinary income, or vice versa.

- (ii) **CIT that encompasses capital gains.** Assuming that the gains from the sale of a capital asset are encompassed within the meaning of taxable income under the regular domestic

CIT, they will be taxable as long as the seller is a company considered to be a tax resident or if it is an international company operating through a permanent establishment in the country. Under this scenario, the gain would be integrated into the general income tax base and the corporate income tax rate would apply.

Countries wishing to relieve the tax burden—because of the general investment climate, or because they consider that transfers of such assets may encourage more motivated, better-equipped buyers—could allow for tax exemption for certain transactions or tax deductions directly related to the transfers, provided certain requirements are met. These exemptions should be carefully considered since they do reduce the overall tax base in a particular year, although they may not affect the overall tax base over the life of the assets. The current trend in income tax systems is for a wider current year tax base combined with lower rates.

Nevertheless, in some countries, the overall fiscal regime that applies to a particular extraction activity may be uniquely crafted pursuant to negotiations. In such cases, additional requirements may be imposed by the government, such as specific obligations to construct or improve infrastructure, train workers, or pay surpluses not required from other types of businesses. As a part of the negotiations, a country may also agree to exempt the extractive investment from certain provisions if it feels, in the overall design of the fiscal regime, that such exemptions are warranted and may promote investment. In such cases, one could envision an exemption from capital gains taxes if, as part of an overall negotiation, the country considers it has compensated itself in other ways through the overall fiscal regime it adopts.

Whatever approach is taken, transparency and a well thought through policy approach is the best way of encouraging other countries to allow a credit for the tax paid or an exemption, if that is a relevant consideration to the parties. Even under a tax treaty, other countries will only consider themselves bound to allow a credit in view of tax paid in the source country that meets the test of being in

accordance with the provisions of the tax treaty. If that is not an issue, there may still be scope for different measurements of the gain. For this reason, openness about the taxation of capital gains, including in treaty negotiations (where a summary of the tax system is often useful and can become an agreed part of the record of the negotiations) and when changes are made to tax rules, is an important component of balancing the need for revenue with the need to have an investment climate encouraging investment for development.

Of course, it does not necessarily follow that a transfer involves a gain, and sometimes the transfer outside the country of extractive activities will involve an indirect sale of ownership interests in many countries (such as in the *Zain vs. Uganda Revenue Authority* case in Uganda, noted in box IV.5 below). In such cases there will need to be a fair assessment of the amount of the gain connected to/sourced in the particular country and then whether and how the gain is taxable under domestic law.

If taxes are imposed on business-related capital gains, it is arguable that, to be even handed, business related capital losses should be deductible against a country's income or capital gains taxes.

### ***Should gains in the extractive industries receive “special” treatment?***

Arguments that gains from asset sales in the extractive industries should be entirely exempt from capital gains taxation usually relate to their use in an active trade or business as opposed to a passive investment activity.

Some countries might consider that unrelieved capital gains taxation might be inappropriate to the class of actively used assets to encourage investments in certain circumstances. For example, Australia has an active assets capital gains tax reduction of 50 per cent, but only for small business. Canada also has certain exemptions for certain types of active businesses, but again only for small business. South Africa does not tax capital gains on the disposal by individuals or small businesses under certain circumstances.

A general exemption might be possible for gains made on extractive industries assets, particularly where returns might, at least

in early years, be more marginal, but such exemptions are not at all common in practice. The lack of a wholesale exemption is supported by (i) public expectations that such gains should, in principle, be shared with the country through taxation, and (ii) on the basis that if the main reason for not having a CGT is to encourage investment, that reasoning may not hold for those cases where there is a general perception that the project would go ahead even without this measure. It should be noted, however, that imposition of a tax on a capital gain generally only accelerates tax paid to a country; it does not increase the overall taxes paid over the life of the investment.

More likely than a special provision exempting the extractive industries from a country's capital gains tax is that countries *without* a general capital gains tax will have a provision bringing gains in that sector into the tax base. Kenya, for example, had been suspending the operation of their CGT since 1985, but in 2012 introduced legislation imposing a 10 per cent final tax on residents (20 per cent non-final on non-residents) for gains on the transfer of shares or property interests in oil and gas, mining or prospecting companies. In 2015, Kenya reintroduced the suspended CGT to tax capital gains generally, but while the general rate is 5 per cent, the rate for the extractive industries is 30 per cent for residents and 37.5 per cent for non-residents with permanent establishments. Note that differential treatment between residents and non-residents *may* raise tax treaty issues of “non-discrimination,” such as under Article 24 of the United Nations Model Convention. The taxable gain is the net gain derived on the disposal of an interest in a “person,”<sup>132</sup> if the interest derived its value from immovable property in Kenya. “Immovable property” in this context meant a mining right, an interest in a petroleum agreement, mining information or petroleum information.<sup>133</sup>

---

<sup>132</sup> The term “interest in a person” includes a share or other membership interest in a company, an interest in a partnership or trust, or any other ownership interest in a person — Section 1(1).

<sup>133</sup> See Kenya Revenue Authority (KRA) CGT Guidelines, Paragraph 13 (January 2015). Available at <http://www.revenue.go.ke/notices/pdf2015/Capital-Gains-Tax-Guidelines.pdf>.

Paragraph 13 of Guidelines dated April 2016, but no longer available on the Internet, indicated the same.

Late that same year, Finance Act 2015 changed the law so that gains from the disposal of shares of a non-local holding company (i.e., an indirect transfer) would not be subject to CGT in Kenya. There is, however, a special rule for oil and gas companies. Paragraph 14(1) of the Ninth Schedule to the Income Tax Act (which deals with taxation of petroleum operations<sup>134</sup>) imposes an obligation to immediately notify (it is not a taxing obligation) the Commissioner if there is a 10 per cent or more change in the underlying ownership<sup>135</sup> of a company operating in the mining, oil and gas sector.

The same paragraph provides that “[i]f the person disposing of the interest to which the notice under subparagraph (1) relates is a non-resident person, the licensee or contractor shall be liable, as agent of the non-resident person, for any tax payable under this Act by the non-resident person in respect of the disposal”.

The net gain from the indirect disposal of shares in petroleum companies is subject to tax in a manner similar to the taxation of transfer of rights, as follows:

- Where the interest derived directly or indirectly from immovable property is below 20 per cent of the total value of the interest, the net gain is not taxable;
- Where the interest disposed is between 20 per cent and 50 per cent, the net gain will be taxable using a prescribed formula; and
- Where the interest disposed is above 50 per cent, the net gain will be fully taxable.

Section 17 of the Ninth Schedule provides that “[a]n amount that is by virtue of this Schedule charged to tax under section 3(2) (a) (i) shall be deemed to be income that accrued in or was derived from Kenya”.

Other countries which do not have a general tax on capital gains often have special extractive industries legislation, such

---

<sup>134</sup> Available at [http://kenyalaw.org/lex/actview.xql?actid=CAP.%20470#part\\_XXVII](http://kenyalaw.org/lex/actview.xql?actid=CAP.%20470#part_XXVII).

<sup>135</sup> “Underlying ownership” is defined as an interest in the person held directly, or indirectly through an interposed person or persons, by an individual or by a person not ultimately owned by the individuals.

as New Zealand's provisions that in effect disregard the normal distinction between capital and income returns on asset transfers so that extractives-related capital gains are treated as income. The New Zealand provisions cover, for example, information obtained as a result of exploratory or prospecting activities. However, there are some exceptions in the case of transfers of shares in closely held corporations.

Box IV.1

**A non-governmental organization's view on the issue of timing of receipts<sup>a</sup>**

The view expressed below may be valid based on the assumption that the purchaser in the transaction giving rise to the capital gains tax can deduct the purchase price (including capital gains realized by the seller) from taxable income arising from extractive activities:

It is often argued that it is politically unfeasible in developing countries not to tax billion-dollar sales of the right to exploit national resources. One of the very few ways that a government can extract revenue from extractive sector projects that will not generate a profit for years or even decades is to impose a tax on capital gains. The early injection of substantial revenue from capital gains taxes is obviously very welcome. In some cases, it is seen as a major victory over powerful international companies and a redress to generous tax concessions offered in the original contracts.

The significance of capital gains tax payments is often not well understood. In most countries, the capital gains tax is deductible against future assessments of taxable income. This means that a capital gains tax is not an additional source of government revenue. It does enable the government to bring forward some future revenue. But it also generates additional deductions against company taxable income. Securing early revenue in advance of production delays the onset of profit based taxes (IRPC) and pushes back the date when government revenues will become significant. The resulting offset in medium-term government revenues is considered, if it is even considered at all, a small price to pay for substantial early revenue.

<sup>a</sup> Centre for Public Integrity, *Taxing "Capital Gains" in Mozambique's Extractive Sector* (May 2014). Available at [http://www.cip.org.mz/cipdoc/307\\_Spinformacao\\_2014\\_04\\_en.pdf](http://www.cip.org.mz/cipdoc/307_Spinformacao_2014_04_en.pdf).

Perhaps one important factor in the general taxation of capital gains in the extractive industries is the widespread public view that transfers of large-scale extractive facilities should bring a return to the government, especially as profits are often seen as coming “a long way down the road” or possibly not materializing at all due to economic circumstances or (sometimes) profit shifting arrangements.

In any event, there will be a time value of money advantage for developing countries upon early receipt of consideration for sale of capital assets, as compared to the later receipts of consideration for outputs from the capital assets. Such an advantage may be especially significant for developing countries. Investors, on the other hand, will see a time value of money disadvantage to such a system, and will build that consideration into their overall investment decision-making and their economic projections.<sup>136</sup> That does not necessarily mean they will not invest because of such a common approach to taxation; it may merely factor into expected profits of an otherwise profitable investment.

Rather than a wholesale exemption for the extractive industries from a capital gains tax, far more likely is a tailoring of the application of such a tax to the unique aspects of the industry itself. Thus, as in the instance provided earlier regarding certain corporate restructurings, other transactions and restructuring of asset ownership may also deserve similar exemption or deferral from a potential taxable gain. For example, in many industries, exchanges of assets used in a trade or business that are similar in nature are not taxable immediately. The notion is that each taxpayer has simply continued its investment in

---

<sup>136</sup>Countries and investors do not always view timing differences equally, since the discount rates they use in determining the present value of an income stream often differ. In many cases, the investor’s risk-adjusted discount rates are higher than the country’s rate (generally a borrowing rate); where this occurs, the advantage viewed by a country in accelerating a payment to it may be quantitatively less than the disadvantage an investor sees from such an acceleration. In such a case, there is an overall economic loss. “The fact that timing differences are often more valuable to investors than they are costly to countries on a present value basis is an important tool for countries to use to their benefit.” See, for example, Karl Schmalz, “Capital Gains Issues in the Extractive Industries,” in *Tax Notes International* (October 2016), pp. 91–92.



the assets of its business, and no cash proceeds have been realized. In such a case, some countries defer the exchange of like-kind assets from taxation until the asset received is ultimately sold.

Similarly, most countries encourage investors and businesses to join in conducting a business or making an investment. For example, generally the transfer of assets into a corporation in exchange for an ownership interest (i.e., shares) is not a taxable event. Similarly, the transfer of assets to a partnership to operate a joint business activity is not generally taxable to the partners. Countries examining the scope of taxable events under a tax system that otherwise taxes sales or transfers of assets need to carefully consider application of such taxes to these types of activities.

***What are “farm-out” and “farm-in” agreements and how should they be treated?***

One distinctive characteristic of the extractive industries is that investors often spread their risks (including political, exploration and development risks) by carrying out large natural resource operations jointly.<sup>137</sup> Often these joint ventures are formed after one party has already engaged in substantial activities to acquire licences and conduct exploration activities. As a result of such activities, the value of the initial investment in the extraction project may have substantially increased and, hence, financial exposure has similarly increased. To attract other investors to share in the costs, risks and obligations of developing the project, the initial investor will need to transfer a portion of the project to the new investor, while retaining a smaller portion but with reduced obligations and risks. In most cases, no cash is paid.

In the extractive industries, one way to involve additional investors in such a way is through “farm-out” agreements. Particularly common in the oil and gas industry, in these agreements an owner of an oil or gas interest (the “Farmor”) agrees to assign part of its interest to another party (the “Farmee”) in exchange for certain obligations in connection with development of the oil or gas interest. Sometimes the obligations may include the provision of certain

---

<sup>137</sup>Jack Calder, *Administering Fiscal Regimes for Extractive Industries: A Handbook* (Washington, D.C.: International Monetary Fund, 2014), p.87.

services. More generally, they simply require the new investor to pay a share of all the ongoing costs of exploration and development. In the purely service context (by far the least relevant in large joint venture farm-outs), sometimes these services include drilling a well to a certain depth, in a certain location and in a certain time frame. The agreement also typically stipulates that the well must obtain commercial production. After this contractually agreed service is rendered, the Farmee is said to have “earned” an assignment. This assignment comes after the services are completed, and is sometimes subject to the reservation of an overriding royalty interest in favour of the Farmor.<sup>138</sup> From the Farmee’s perspective these are known as “farm-in agreements”.<sup>139</sup>

More typically with respect to extractive industries projects of large scope, introduction of coventurers simply results in the new investor taking on the responsibility to fund a share of ongoing costs. Generally, these conventional farm-out agreements do not involve cash, or the retention of an overriding royalty. To the extent cash is received, it is generally taxable to the recipient. Where a royalty or overriding royalty is retained, there is no tax due at the time of the farm-out, but tax is paid as income from the royalty, or overriding royalty, is received. The United States of America has long considered the pooling of capital in connection with oil and gas activities as non-taxable under its “pool of capital” doctrine as explained in box IV.3 below. Even where the pool of capital doctrine does not apply, tax rules relating to partnerships provide a similar avenue for effecting joint ventures without tax on formation.

A major consideration in allowing additional partners to join in the ongoing exploration and/or development of natural resources in a non-taxable fashion is to maximize the chances for full development and provide an efficient way of achieving risk sharing. Given the size and extent of the risks involved in large natural resource

---

<sup>138</sup> Austin W Brister, *Farmout Agreements: The Basics, Negotiations and Motivations* (2013). Available at <http://www.Oilandgaslawdigest.Com/Ogagreements/Farmout-Agreements-Basics-Negotiations-Motivations/>.

<sup>139</sup> An example of an actual agreement in the case of coalbed methane resources may be seen at <https://www.sec.gov/Archives/edgar/containers/fix/045/1124024/000119312509054536/dex101.htm>.

developments,<sup>140</sup> policies that facilitate risk sharing will be viewed very favourably by investors. In contrast, policies that in effect place restrictions or additional costs on commonly employed transactions that facilitate risk sharing can make a prospective investment significantly less attractive.<sup>141</sup>

The capital gains treatment of farm-outs has great scope for uncertainty, in part because of their frequent complexity, and tax administrations are tending to give them increased scrutiny.<sup>142</sup> How they may operate in tax terms needs to be closely considered by administrations and the participants. Of course, how a country's tax system treats the formation of a joint venture to develop an extractive project will inevitably have some consequences as to a potential investor's decision whether or not to go forward with the development opportunity, and if so, how.<sup>143</sup>

---

<sup>140</sup> See, for example, *International Energy Agency Special Report on World Energy Investment Outlook 2014 Special Report*, p. 32, for a list of the risk factors investors face.

<sup>141</sup> Given that over the life of the project the same amount of taxes should be collected, the timing benefits to the country of receiving some of this revenue at an earlier period must be weighed against a permanent loss of revenue if a project does not go forward, or is not as fully developed as it otherwise could be as a result of these policy choices.

<sup>142</sup> See, for example, Greenwoods and Freehills, "Tax certainty for farm-outs?", in *Tax Brief* (September 2011). Available at [http://www.greenwoods.com.au/media/1308/tax\\_brief\\_tax\\_certainty\\_for\\_farm-outs.pdf](http://www.greenwoods.com.au/media/1308/tax_brief_tax_certainty_for_farm-outs.pdf). The Australian Taxation Office Rulings referred to MT 2012/1 and 2012/2 are available, respectively, at <http://law.ato.gov.au/atolaw/view.htm?docid=MXR/MT20121/NAT/ATO/00001> and <https://www.ato.gov.au/law/view/document?docid=MXR/MT20122/NAT/ATO/00001>.

<sup>143</sup> See, for example, the discussion in Denis Kakembo, "How to keep investors" taps flowing as global oil prices head to rock bottom", in *The East African* (February 2015). Available at <http://www.theeastafrican.co.ke/OpEd/comment/How-to-keep-investors--taps-flowing-as-global-oil-prices-fall/434750-2616576-item-1-h80dmqz/index.html>. For other examples and templates see example <https://www.ampla.org/modeldocuments/documents/model-documents52>; <https://www.otciq.com/otciq/ajax/showFinancialReportById.pdf?id=108854>; <http://www.okbar.org/members/BarJournal/archive2005/Mayarchive05/obj7615oil.aspx>; and Michael L. Covey Jr., *Documenting the Oil and Gas Farmout Agreement* (2005).

## Box IV.2

**Services performed for oil and gas property interests<sup>a</sup>**

1. Frequently promoters, accountants, lawyers, geologists, operators, and others receive an interest in an oil and gas drilling venture in return for services rendered. These services may have been rendered in acquiring drilling prospects, evaluating leases, packaging the drilling programme, or, in general, administrative services such as formation of partnerships, filing with Securities and Exchange Commission (SEC) and other functions.
2. It is a common practice for the promoter or sponsor of a drilling package to acquire part or all of the interest in the drilling venture in return for services. GCM 22730, 1941-1 CB 214, provided that the receipt of an interest in a drilling venture in return for capital and services furnished by a driller and equipment supplier was not taxable on receipt. This ruling provided for the “pool of capital” doctrine that is widely quoted in oil and gas tax law. The same reasoning has been extended to geologists, petroleum engineers, lease brokers, accountants, and lawyers who receive an interest in an oil or gas drilling venture in return for services rendered. This doctrine resulted from the court decision in *Palmer vs. Bender*, 287 U.S. 551 (1933); 1933-1 C.B. 235; 11 AFTR 1106; 3 USTC 1026.
3. The “pool of capital doctrine” is widely accepted by accountants and lawyers and is still quoted to justify the tax-free receipt of property for services. Subsequent changes in the tax laws and subsequent court cases have significantly limited the use of GCM 22730. (...)
8. While the pool of capital doctrine is still viable in specific factual circumstances, it does not equate to a special exemption from IRC 83 for the oil and gas industry. Generally, for the pool of capital doctrine to apply all of the following must occur:
  - A. The contributor of services must receive a share of production, and the share of production is marked by an assignment of an economic interest in return for the contribution of services.
  - B. The services contributed may not in effect be a substitution of capital.
  - C. The contribution must perform a function necessary to bring the property into production or augment the pool of capital already invested in the oil and gas in place.
  - D. The contribution must be specific to the property in which the economic interest is earned.

- E. The contribution must be definite and determinable.
- F. The contributor must look only to the economic interest for the possibility of profit.

**a** Internal Revenue Service, Oil and Gas Handbook, section 4.41.1.2.3.1. Available at [www.irs.gov/irm/part4/irm\\_04-041-001.html](http://www.irs.gov/irm/part4/irm_04-041-001.html).

### **Taxation of gains from indirect transfers as an option**

When making policy decisions, each country must consider its own circumstances in determining whether or not it should tax gains made from indirect transfers. If a country decides to tax indirect transfers, the question is how that should be done, taking into account the tax policy aspects addressed in this chapter. There are increasing expectations, including from the broader citizenry, that if direct transfers of a mine or other extractive facilities are subject to taxation on the gains made, an indirect transfer should have the same effect in revenue terms, despite the lack of any change in the direct ownership of the assets, and the separate legal entity status of distinct companies in the chain of ownership.

In tax policy terms, the position is often taken that the soundness of the system for taxing direct transfers of interests requires the taxation of indirect transfers that otherwise have the same characteristics; otherwise those with the means to do so will simply structure transfers indirectly. The value of extractive facilities is no doubt one reason for the particular focus on indirect transfers of such facilities, and one of the ways a multinational can extract profits from the extractive industries is through the sale of shares. The issue also arises in other areas also, such as in connection with real estate holdings and telecommunications assets. It is fair to say, however, that the information and other compliance and enforcement issues in taxing indirect transfers are not sufficiently discussed in detail in such debates, even if legislation can be drafted in a way that seeks to deal with these issues, as noted below.

Apart from the compliance and enforcement issues, another argument given for not taxing indirect transfers is that the production of income from the domestic mine or oil and gas assets continues to be subject to taxation; thus, no tax revenue is lost to the country. While there is a timing difference on the collection of tax revenues, the

absolute amount does not change. This is because if the gain is taxable, in order to avoid double taxation, the domestic asset values need to be increased for tax purposes by the amount of that gain, giving rise to higher ongoing depreciation and depletion deductions and a corresponding reduction in future tax receipts. Given the fact that the total amount of taxes ultimately paid will not change (if the tax value of the domestic asset values is increased) a country needs to balance the revenue timing benefit versus the complexity of compliance and enforcement that arises from seeking to tax such indirect sales.

#### Box IV.3

##### **An example of asset transfer taxation: Norway<sup>a</sup>**

As a starting point, capital gains/capital losses arising from the transfer of assets located on the Norwegian continental shelf are taxable/deductible (...)

However, in practice, most asset deals are exempt from tax based on provisions in section 10 of the PTA. According to section 10, an approval from the MOF [Ministry of Finance] is required with regard to the tax effects of a transfer of assets that are under the petroleum tax regime, provided that consent to the transfer is needed from the MPE [Ministry of Petroleum and Energy]. Consent from the MPE is needed upon a direct or indirect transfer of a licence and where the assets will follow the transfer of the licence. This is applicable if all fixed offshore installations pertaining to a licence are transferred (even if the licence itself is not transferred).

According to regulations adopted based on section 10 of the PTA, capital gains arising from the transfer of assets that are allocated to the petroleum tax regime are not taxable and losses non-deductible (neither when calculating ordinary petroleum tax nor special tax). Moreover, the buyer will take over the seller's tax balances (including the basis for uplift) and other tax positions and stand in the shoes of the vendor.

There are also specific provisions in the regulations dealing with transfers where one of the parties covers future explorations costs, or where the seller covers future abandonment costs pertaining to the assigned interest. Broadly, the regulations state that it will be the party who will eventually bear the costs that may deduct those costs and claim a refund of the tax values of those costs when they accrue (i.e., according to the same system that would apply to the seller if the licence was kept). (...)

The rationale for these rules is that the Norwegian state tax revenues from upstream activities should be unaffected by a transfer. (...)

Consent from the MOF is also required for an indirect transfer such as a share deal implying a change of control. Such deals are, in practice, straightforward from a tax perspective as there are no withholding taxes regardless of where the shareholder is a resident.

- a** The text of this box is quoted from: Deloitte Touche Tohmatsu Limited, Oil and Gas Taxation in Norway (Stavanger, Norway, 2014), p. 6. Available at <http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Energy-and-Resources/gx-er-oil-and-gas-taxguide-norway.pdf>.

Another argument commonly made against the taxation of indirect transfers is that, because of the separate legal entities involved, taxing such transfers occurring in a foreign country—and which do not involve any domestic residents as a party to the transfer—in effect constitutes extraterritorial taxation of foreign economic activity by foreign people. It should also be borne in mind that taxing indirect transfers affects the price of the transaction, as the seller will factor the tax to be paid into the selling price of the shares.

The contrary view is that a certain degree of extraterritoriality is well supported in international law and is often explicitly part of domestic law.<sup>144</sup> It is expressed in the Government of India's 2012 Draft Report on Retrospective Amendments Relating to Indirect Transfer Expert Committee, which noted that:

[I]n the case of *Electronics Corporation of India Ltd.* (ECIL) the Supreme Court referred the matter, being of substantial public importance, to a Constitution Bench after making the following observations:

- The operation of the law can extend to persons, things and acts outside the territory of India.
- Reliance was placed on the decision of the Privy Council in the case of *British Columbia Electric Railway Co. Ltd. v. King* [1946]

<sup>144</sup> See, for example, the influential Statute of Westminster, section 3: “It is hereby declared and enacted that the Parliament of a Dominion has full power to make laws having extra-territorial operation”. Although an Act of the United Kingdom of Great Britain and Northern Ireland Parliament, this Act established the legislative independence of what were then the self-governing Dominions of the British Empire. Available at <http://www.legislation.gov.uk/ukpga/Geo5/22-23/4/section/3>.

AC 527, 542 (PC) wherein it was stated that “A Legislature which passes a law having extra-territorial operation may find that what it has enacted cannot be directly enforced, but the Act is not invalid on that account, and the courts of its country must enforce the law with the machinery available to them.”

- The provocation for the law must be found within India itself. Such a law may have extra-territorial operation in order to sub serve the object and that object must be related to something in India. It is inconceivable that a law should be made by Parliament in India which has no relationship with anything in India. However, the matter was not pursued by the applicant, being a public-sector company, and therefore it is still an open issue. The decision did clarify one issue that, on the grounds of non-enforceability in India, a law cannot be held as invalid. The reference was, however, made on the second issue, i.e., whether there was sufficient nexus with India or not.<sup>145</sup>

Cameroon amended its legislation in 2014 to deal with the matter quite explicitly. Law No. 2014/026 of 23 December 2014 on the Finance Law, amended existing legislation as follows:

**Section 42:** The following shall be taxable as (...) net overall capital gains realized in Cameroon or abroad during the transfer, **even indirect**, of stocks, bonds and other capital shares of enterprises governed by Cameroonian law (...).

**The indirect transfer of stocks, shares and bonds of enterprises governed by Cameroonian law including notably any transfer made in Cameroon or abroad between two foreign companies under the same consolidation scope when one of the entities of this scope, completely or partially, holds the share capital of an enterprise governed by Cameroonian law.**<sup>146</sup>

Countries asserting tax jurisdiction over indirect transfers will usually need to explicitly assert jurisdiction over both the transfer and the transferor (even if they also claim jurisdiction over a local

---

<sup>145</sup> See paragraph 4.1.1. Available at [https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/21/Draft\\_Report.pdf](https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/21/Draft_Report.pdf).

<sup>146</sup> Available at <http://www.prc.cm/en/multimedia/documents/3310-finance-law-of-the-republic-of-cameroon-for-the-2015-financial-year>.



entity, such as in an agency capacity or because it has failed to notify of the indirect disposal as required by law) and will also generally need to provide that it is to be treated as a domestically sourced gain. Ecuador provides in Article 8 of its domestic tax law, for example, that the following category of income is deemed to be from an Ecuadorian source:

3.1. The profits obtained by companies, regardless of whether they are domiciled in Ecuador or not, and Ecuadorian or foreign individuals, regardless of whether they are resident in the country or not, derived from the disposal, be it direct or indirect, of shares, equity participations, other claims to capital or other rights permitting exploration, production, concession or similar activities, of companies that are domiciled or permanent establishments in Ecuador.<sup>147</sup>

Some countries take positions that judicial or legislative anti-abuse rules, such as a general anti-avoidance rule (GAAR), apply to indirect transfers. For example, the People's Republic of China's State Administration of Taxation issued new administrative guidance on application of their GAAR in 2015 to recharacterize an indirect transfer of certain properties as a direct transfer of the same.<sup>148</sup> Those favouring GAARs point to the need to cover types of conduct (abuses) and discourage them rather than merely addressing specific types of such abusive conduct, providing a possible "road map" for tax avoidance.

One issue that may arise when GAARs are relied on in the case of indirect transfers is that of whether there is a "treaty override" occurring. The circumstances when GAARs may or may not be in compliance with tax treaties are discussed in the Commentary to Article 1 of both the United Nations and OECD Models Conventions.

---

<sup>147</sup> SRI (Internal Revenue Service of Ecuador) presentation, Treatment of capital gains in mining projects in Ecuador (September 2015). Available at <https://www.imf.org/external/spanish/np/seminars/2015/andean/pdf/sesion2-delgado-en.pdf>.

<sup>148</sup> See Baker and McKenzie, Breaking News: China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698 (February 2015). Available at <http://www.lexology.com/library/detail.aspx?g=b8226983-cb9e-4575-8ce8-cb9283a41706>.

By using domestic law to address certain indirect sales as “abusive” it follows of course that the scope of the anti-abuse rules would be necessarily limited to what constitute abusive transactions in the terms of the relevant legislation (including any requirements of proof that fall upon the tax administration) and this might not always be seen by a country as sufficient for properly achieving the goals of taxing capital gains derived from extractive assets. If officials are not confident that such anti-abuse rules will be applied by courts to indirect transfers in the same way as for direct transfers, more specific domestic legislation would be necessary to achieve this result. Such specific domestic legislation does not necessarily have to be a special anti-abuse (or anti-avoidance) rule (a SAAR) and can be applicable to more types of transactions.

Treaty abuse and the use of a GAAR have been the subject of some discussion in some recent Indian cases relating to indirect transfer of assets that might otherwise be subject to taxation in India. Such cases include *Vodafone International Holdings B.V. v. UOI & another*<sup>149</sup> and *Sanofi Pasteur S.A v. Dept of Revenue*.<sup>150</sup> *Vodafone* addresses the taxability of an offshore transfer of shares with their underlying value being assets in India. The case concerns the transfer of shares of CGP, a Cayman based subsidiary of HTIL, owned by the Hutchinson group, to Vodafone, a company incorporated in the

---

<sup>149</sup> *Vodafone International Holdings B.V. v. UOI & another* [2012] 341 ITR 1 (SC). Available at <https://indiankanoon.org/doc/115852355>.

<sup>150</sup> *Sanofi Pasteur Holding SA v. Dept of Revenue* [2013] 30 taxmann.com 222 (AP). Available at <https://indiankanoon.org/doc/171254621/>. See also in this respect, *Canada-Mill Investments S.A v. Her Majesty the Queen*, Case number 2004-3354 (IT) G, Tax Court of Canada, 19 August 2006, concerning a complex tax reorganization and restructuring in order to (i) avoid the incidence of capital gains tax in Canada (the underlying asset responsible for the capital gain was a deposit of nickel, copper and cobalt in Canada; and (ii) obtain a more favourable jurisdiction from which to invest in mines in Africa. The court found that the Canadian GAAR would not apply in this case because there was no avoidance transaction. There was an underlying issue related to the application of Article 13(4) in the treaty between Canada and Luxembourg, but the court found that there was no abuse in the use of the treaty, and that the Canadian tax authorities must have had a good reason to allow Luxembourg to retain taxing rights over the transaction.

Netherlands. HTIL owned Hutchinson's operations in India through a series of companies incorporated in Mauritius.<sup>151</sup>

The tax authorities notified Vodafone of what they considered its failure to withhold taxes on gains arising to HTIL from the transfer of shares to CGP, based on the argument that the sale of shares resulted in an underlying sale of assets located in India. The case was examined by the Indian Supreme Court and it found for Vodafone, deciding that no taxes were payable in India on the indirect transfer. The Indian Government subsequently enacted retroactive amendments to the Finance Act of 2012, which in effect reversed the effect of the court decision.<sup>152</sup>

Soon after the Vodafone case, the Andhra Pradesh High Court had a similar case submitted to its adjudication with a similar result: the *Sanofi Pasteur Holding SA v. The Department of Revenue* case. In *Sanofi*, the issue was whether the gains arising from the offshore transfer of shares of a French company holding substantial interest (80 per cent) in an Indian company, were subject to tax in India. As in *Sanofi*, the revenue authorities contended that the transaction attracted capital gains tax in India because it resulted in an indirect transfer of assets in India. The High Court concluded that the French company could not be disregarded as a legal entity merely because it was regarded as an intermediary holding company. As a result, there was no treaty abuse. The decision was based on the tax treaty between France and India, which gave the taxing rights of the transaction to France. Although the *Vodafone* and the *Sanofi* cases both ruled for taxation by the residence country, these cases go to show that countries which typically hold activities and generate value are becoming ever more vigilant towards indirect asset transfers.

Differences will exist among the revenue authorities and the courts of different countries on how these indirect transfer cases

---

<sup>151</sup> M. Butani, *Tax Dispute Resolution—Challenges and Opportunities for India*, Lexis Nexis, Crier, (2016) pp. 47–48.

<sup>152</sup> The 2012 Finance Act of India has sought to include specific anti-avoidance rules relating to indirect transfers of capital assets by (i) taxing capital gains even when the transfer price is not ascertainable/determinable and (ii) imposing the onus on the holding company to prove the source of income of a resident shareholder, among others.

should be assessed against the law; the possibility of double taxation, therefore, arises (although many transfers would be structured to avoid also taxes abroad). However, there is also a risk to buyers of an unexpected liability arising in a foreign country and that it might impact the ability to effectively or profitably utilize the purchased asset. This is likely to have an impact on the investment climate of a country.<sup>153</sup>

As recognized in the Commentaries to Article 1 of both the United Nations and OECD Model Conventions, issues of treaty override may also arise in the case of specific legislation. Countries proposing or having legislative provisions dealing with indirect transfers therefore need to at least consider their relationship to treaty obligations; of course, it is always advisable to notify negotiation partners of legislation addressing such issues and to keep treaty partners advised of changes in such legislation. In particular, even if local courts accept that the domestic law must be followed (either because it is compatible with the treaty applying accepted rules of treaty interpretation, or because it must be applied by the court even if inconsistent, i.e., they do not have a constitutional or other provision giving treaties supremacy over legislation) there is no guarantee that the other country will accept this (especially in the latter case) and give credit for the taxes paid as a result of the judgment.

Box IV.4

**Uganda: *Zain vs. Uganda Revenue Authority*<sup>a</sup>**

In September 2014, an appeals court in Uganda ruled in favour of the Uganda Revenue Authority (URA) in the *Zain vs. Uganda Revenue Authority* case. Shares in the Netherlands company Zain Africa BV, that owned 100% of a Ugandan telecommunications provider, were transferred between two Dutch companies (from Zain BV to Bharti A BV) and it was argued that even if taxation was allowed under domestic law, under the Netherlands-Uganda tax treaty, Uganda had no taxing right preserved (there was no equivalent to the United Nations or OECD Article 13(4)) of their respective Models). The URA was able to apply Section 88(5) of Uganda's Income Tax Act to preserve its taxing right. This section provides that:

---

<sup>153</sup> Investors seek certainty and the reduction of risks. They highly value legal systems that are predictable and clear. When a country changes its rules after investments have been made or transactions have occurred in reliance on then existing statutes or other rulings, uncertainty increases, and future investment will be affected.

[w]here an international agreement provides that income derived from sources in Uganda is exempt from Ugandan tax or is subject to a reduction in the rate of Ugandan tax, the benefit of that exemption or reduction is not available to any person who, for the purposes of the agreement, is a resident of the other contracting state where 50 per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other Contracting State for the purposes of the agreement.

The argument would be that the United Nations and Organization for Economic Cooperation and Development (OECD) Models both give (in their Commentaries to Article 1) some latitude for domestic anti-avoidance rules to operate consistently with a treaty, and that Section 88(5) met that test. The alternative would be that it was inconsistent with the treaty and could not operate in domestic law in this case. The Court ruling overturned an earlier High Court decision that Uganda had no jurisdiction to tax. It decided the case on a narrow procedural ground, however: The URA had originally assessed it as an ordinary capital gain, but when challenged by the taxpayer they revised their assessment to treat the Uganda company that had changed hands via the Netherlands holding company as one deriving most of its value from immovable assets. The taxpayer's challenge was that the revenue authority had not followed the correct process in changing the grounds of its assessment, but the court held that the URA did have the right to reassess the taxpayer. It did not pronounce on whether that revised assessment would be valid. The decision did not finally dispose of the case and the issue of treaty compatibility of Section 88(5) but the matter was sent back to the URA to consider whether and if so what amount of gain was sourced in Uganda and taxable.

- a** See, for example, Daniel K. Kalinaki, "Court gives URA nod to seek taxes on sale of Zain assets in Uganda," in *The East African* (September 2014). Available at <http://www.theeastafrican.co.ke/news/URA-taxes-on-sale-of-Zain-assets-in-Uganda/-/2558/2451578/-/item/0/-/6hm2he/-/index.html>.

There are other reasons often favouring SAARs rather than relying on a GAAR, and in recent years there has been a great deal of such legislation in Africa to attempt to counter indirect transfers in the extractive industries.<sup>154</sup> These reasons include that SAARs can be more precise about who must bear the compliance obligations, and what the

<sup>154</sup> Kennedy Munyandi and others, "Tax Policy Trends in Africa—Commentary on the Major Tax Developments in 2013 and 2014", in *Bulletin for International Taxation* (March 2015), pp. 154, 158–9.

obligations are. A SAAR can, for example, focus on related party transfers, minimum shareholdings and off-stock exchange transfers to limit the impact on transactions that are not considered to be high risk. Finally, a SAAR need not depend on a “purpose” test (which can be difficult to prove for whomever bears the onus of proof, create uncertainty for both administrations and taxpayers and can involve a great deal of discretion on the part of officials). Instead it can more “scientifically” make an indirect transfer taxable irrespective of the purpose of the transfer by, for example, treating it as equal to a direct transfer.

Any such legislation needs to be seen (like a GAAR) in the context of a country’s tax treaty network. Tax treaties cannot give a taxing power that does not exist in domestic legislation, but they can either allow it to continue to be exercised or can prevent it from being exercised. It is therefore important that a country’s tax treaties preserve the right to apply the domestic legislation in that treaty relationship. It is also strongly advisable that all treaties consistently preserve these rights, otherwise there would be an inducement to use treaty shopping techniques to have a transfer occur in a state against which the domestic legislation of the other state is overridden by treaty rules (i.e., where no taxing right is preserved). This issue is discussed further in the section on symmetry following.

### **The issue of symmetry**

Whatever approach is taken to the application of a general or specific capital gains tax provision, one factor in the policy decision is the possibility of asymmetries of treatment.<sup>155</sup> From the revenue perspective, a country would not want to allow a purchaser to take current or future deductions based on the purchase cost of an asset if the country has a capital gains tax but is, for whatever reason, unable to tax capital gains derived by the seller of the asset. This situation could arise where a transfer is either untaxed or concessionally taxed (as compared with income gains). Thus, where a gain is treated as a capital gain and is either untaxed because the country does not have a CGT, or concessionally taxed under the CGT, then there will be asymmetric tax treatment between the transferor and transferee, as

---

<sup>155</sup> See Annex II to this Handbook with worked examples illustrating the significance of the issue of symmetry.

the transferee's cost represented by the gain is likely to be deducted at the normal corporate tax rate.

On the other hand, it may deter economic activity if the seller's capital gains are taxed but no deductions are available to the purchaser for the cost of acquiring the asset in the form of depreciation or cost-basis in the asset that can be deducted when calculating taxable income (including capital gains) in the future.

For example, in a case where an indirect transfer is recharacterized as a direct transfer, the built-in gains in the assets held by the underlying domestic corporation will be essentially taxed to its shareholder-seller. In this case, symmetry may be regarded as being maintained between the seller and the purchaser, since the purchaser's basis in the shares in the domestic corporation would be the purchase price paid to the seller, for which the seller realized capital gain. However, without a specific statutory rule, the basis in the assets owned by the domestic corporation would remain unchanged (i.e., not stepped-up for the amount of capital gains already taxed in the seller) and this can be regarded as an asymmetry.

In contrast, some countries address an indirect transfer by deeming a transfer and the subsequent re-acquisition by the underlying domestic corporation of assets owned and liabilities owed by that corporation immediately before the underlying ownership changed,<sup>156</sup> thus, confirming a liability to domestic tax. In those cases, symmetry will be maintained, since the domestic corporation acquires a cost-basis in the assets deemed to be acquired which can be deducted in the future for tax purposes. Implications for countries deeming a transfer and re-acquisition by the underlying domestic corporation are that the corporation would not have access to the consideration for the actual transfer of shares or other indirect interests to pay the tax, and the increased future deductions by the corporation will negatively impact taxes payable in future on its reduced taxable income. One possibility would be conditioning the basis "step up" to the purchaser on the revenue authority receiving the tax from (or on behalf of) the seller.

---

<sup>156</sup>See, for example, the United Republic of Tanzania Income Tax Act 2004 (as amended), S.56. Available at <http://www.wipo.int/wipolex/en/details.jsp?id=11106>.

Where countries frame their indirect transfers legislation relatively narrowly in order to deal with what are perceived as abusive cases (less likely to involve unsuspecting buyers and sellers and more likely to involve a purpose of avoiding tax on a transfer) they may be less willing to grant symmetrical benefits to the buyer. In such cases, there is probably an intention to bring about the result that the buyer will ensure the right amount of tax is paid on the gain—especially since the buyer may otherwise be a beneficiary from the seller not paying taxes on the transfer—through paying a lower price, albeit with lower deductions over time. The possible imposition of a “double” penalty (i.e., on both buyer and seller) should be recognized and evaluated in policy terms, however, and the impact on any unsuspecting buyers should be borne in mind in framing any legislation. There could possibly be a provision allowing the buyer to obtain symmetrical benefits if the buyer can prove *bona fides* through a demonstrated lack of either (i) awareness of; or (ii) negligence as to, the abusive purpose/lack of reasonable commercial purpose.

Countries will also take different views on how to ensure symmetry, since this can be done by either (i) taxing gains to the seller but allowing a deduction for the buyer based on the purchase price; or (ii) not taxing the seller and not granting deductions to the buyer. The former approach might be preferred by those desiring payments as early as possible, and with less concern regarding the budgetary implications of the “lumpiness” of revenues and difficulty in predicting such payments, or the impact on investors or on those having a sense that the impact on investors is reasonable in the context of the agreement as a whole. The latter approach might be preferred by countries who are confident that future profit will be properly recorded and will be taxed in practice, who regard such profits as more predictable over time and who desire to preserve such revenues for future needs.

### **Indirect transfers and corporate structuring and restructuring**

There are many business reasons unrelated to taxation for corporate restructuring, such as adapting to changes in markets, the way in which a business is conducted, or in management approaches. Restructuring could, for example, be undertaken in preparation for a share market float, to prepare for a transfer of some or all of the business, or to raise



capital. Such a restructuring can lead to disposals and could lead to an indirect transfer of an asset in another country.

Some countries provide capital gains relief for dispositions arising from certain types of corporate restructuring, such as between related companies. South Africa's rollover relief for asset-for-share transactions, amalgamation transactions and intra-group transactions is an example.<sup>157</sup> One policy issue is whether—and, if so, why—there should be any different result if the same type of exempt direct transfer were done as an indirect transfer.

In relation to its Public Notice 7 on indirect transfers (considered below) for example, China addresses these issues by providing relief for internal group restructurings that meet certain specified requirements: (i) a more than 80 per cent equity relationship exists between the transferor and the transferee; (ii) the tax burdens in China for any subsequent indirect transfer would not be less than that for the same or similar indirect transfer were it to be conducted instead of the indirect transfer at issue; and (iii) the consideration paid by the transferee only consists of equity of the transferee or its affiliates.<sup>158</sup> Even in reorganizations or acquisitions involving unrelated parties, a question arises as to whether such transactions should trigger indirect taxation events wherever the acquired entity has subsidiaries or other business operations. For example, when one publicly listed major enterprise combines with another via a merger transaction, clearly not motivated as a means of avoiding local taxation, countries may often decide to limit their indirect transfer jurisdiction.

### **What are the double-tax treaty aspects?**

Tax treaties are generally regarded as not creating taxing rights that do not exist in domestic law, but they can prevent or limit the operation of domestic law where that is for the benefit of taxpayers of the countries entering those treaties. This means that if the domestic law

---

<sup>157</sup> See sections 42, 44 and 45 of South Africa's Income Tax Act of 1962.

<sup>158</sup> See Baker and McKenzie, *Breaking News: China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698* (February 2015). Available at <http://www.lexology.com/library/detail.aspx?g=b8226983-cb9e-4575-8ce8-cb9283a41706>.

of a country provides for the taxation of offshore indirect transfers, the tax treaty between that country and the country of residence of the seller of the interest will need to be examined to see if it (i) allows the domestic law to operate as intended; or (ii) restricts the operation of the domestic tax law to the advantage of a taxpayer covered by the treaty. The consequences of this relationship between tax treaties and domestic law are that:

- (i) If there is no domestic law in place taxing gains from indirect transfers, the treaty will not address the deficiency by creating a taxing right;
- (ii) Any treaty right conferred to the country of location of the assets subject to an indirect sale merely represents an unexercised right to taxation unless and until the domestic law is amended to tax indirect transfers;
- (iii) A treaty right to tax need not have all the detail of the domestic law, but it needs to be broadly expressed if it is to cover all the situations foreseen under domestic law (as in the United Nations and OECD Model Conventions discussed below); and
- (iv) The treaty may limit the operation of domestic law to the extent that the right preserved is narrower than domestic law or no taxing right is preserved. Any attempt to change that by amending domestic law may be a treaty override contrary to the terms of the treaty.

The relationship between a tax treaty and domestic law was raised in *Resource Capital Fund III LP v. Commissioner of Taxation* (Australia).<sup>159</sup> Resource Capital Fund III LP (RCF) was a limited partnership formed in the Cayman Islands. In 2006, it bought shares in St. Barbara Mines Limited (SBM), an Australian company that conducted gold mining activities in Australia. In 2007, RCF sold some of its shares in SBM to unrelated parties with a gain. RCF's affairs were managed from a Delaware Limited Liability Company (LLC), based in the United States, which is the reason why the US treaty was invoked in this case. Many of the limited partners were also US based.

---

<sup>159</sup>Case number (3013) FCA 636, Federal Court of Australia—Full Court, 3 April 2014.

The issues in RCF were whether (i) the Commissioner was allowed to issue an assessment to RCF or whether the treaty precluded him from doing so; and (ii) if the Commissioner was able to issue the assessment, whether the gain realized by RCF was subject to tax in Australia under the domestic tax law provisions. The Full Federal Court concluded that since the LP is not a US resident for treaty purposes, the Australia-US treaty did not apply to it and, therefore, the treaty could not prevent the operation of the domestic rules that treated the LP as a separate taxpayer making the gain in Australia. Therefore, in this case, the domestic law prevailed, since no applicable treaty existed to limit that law's operation, and the capital gain was regarded as sourced and taxable in Australia.<sup>160</sup>

Assuming that domestic law on taxation of indirect transfers is in place or is being kept open as a possibility, the question is then whether the treaty limits such an exercise of taxing rights and thereby overrules the legislation to some degree. To consider that issue, the provisions on capital gains of a specific tax treaty (often Article 13) have to be studied:

Box IV.5

**Australia: *Lamesa v. Commissioner of Taxation*<sup>a</sup>**

In *Lamesa v. Commissioner of Taxation*, the issue was whether Lamesa Holdings BV, a Dutch company, was liable to pay income tax under Article 13(2) of the Australia-Netherlands treaty in respect of profits made by it from the sale of shares in a publicly listed Australian company. In 1992, a US business became interested in acquiring an Australian listed mining company. To this end, a US investment vehicle was established which acquired an Australian subsidiary. A Dutch company was interposed. The Australian subsidiary then acquired another Australian company that, in turn, acquired a 100% interest in the listed mining company in a takeover. That mining company owned a subsidiary which held a number of mineral exploration rights. In 1994 and 1996, the Dutch company sold its shares in the first Australian subsidiary, first by way of flotation on the stock exchange and the balance by way of private sale. The Dutch company was assessed a capital gains tax on the profits made from its sale of these shares. Objections against these assessments were allowed. However, further assessments were then issued on the basis that the

---

<sup>160</sup>Leave to appeal was refused by the Australian High Court.

profits of some \$200 million were ordinary income of the company. This time, objections were disallowed and the company appealed.

The company relied on Article 13 of the treaty to argue that the profits were excluded from Australian tax. Article 13 deals with alienation of assets and operates as an exception to the general rule in Article 7 dealing with business profits. Article 7 provides that profits of Dutch enterprises are only taxable in the Netherlands unless the enterprise is carried out in Australia through a permanent establishment. The Australian Taxation Office (ATO) accepted that the company did not have a permanent establishment in Australia. At the time of the conflict, Article 13(2) provided that Australia could tax income from the alienation of real property situated in Australia. "Real property" was defined in the treaty to include direct interests in land, exploration rights and shares in companies with assets principally consisting of interests in land or exploration rights. The Federal Court held that Article 13(2) did not apply to allow Australia to tax the profits made by the Dutch company on the sale of shares in its Australian subsidiary. The company did not acquire direct interests in land or any exploration rights. Note that, despite a frequent analysis of this case, it seems that the reference to direct interests only was not critical ("direct" interests referred to the inherent nature of the interests, not how they were held, i.e., directly as opposed to indirectly held).

(1) Upon consideration as to whether Art. 13(2)(a)(iii) of the treaty should be construed so that the words "the assets of which" extend to assets of various companies down the line of a chain of companies, or should be restricted so that the words bear their literal meaning, the Court decided that Art. 13(2) did not apply to give Australia exclusive taxing rights over the profit on the sale of the shares. Rather, the profits fell to be taxed exclusively under Dutch law (which happened to provide an exemption for these profits).

(2) The words of Article 13(2) are to be given their literal meaning. The assets of the company that were sold could not be taken to extend to the mining interests held through the chain of subsidiaries. When the law speaks of the assets of a company, it invariably does not intend to include the assets belonging to another company, whether or not held in the same ownership group.

In response to this decision, section 3A was inserted into the International Tax Agreements Act 1953 (the Act that incorporates Double Tax Agreements into Australia's domestic tax legislation). This amendment clarified the meaning of terms used in the Alienation of Property Article in Australia's Double Tax Agreements. The intention of this amendment

was to ensure that the Alienation of Property Article was read to cover alienations of shares or other interests in companies, and in other entities, whose assets consist principally of Australian real property, whether held directly or indirectly through a chain of interposed companies or other entities.

- a** *Lamesa Holdings BV v. Commissioner of Taxation*, 20 August 1997, IBFD Tax Treaty database. With additional United Nations/Department of Economic and Social Affairs (UN/DESA) comments.

Assuming the sort of indirect transfer illustrated (at a very basic level) in figure II of this chapter, how will the basic provisions of Article 13 of the United Nations Model addressed in box IV.7 apply?

- **Paragraph 1** would obviously not apply, as there is no alienation of the immovable property itself, at least directly. The general anti-avoidance rules in tax treaties, as provided for in the Commentaries to Article 1 of the United Nations and OECD Model Conventions, may in some countries allow for coverage of indirect transfers, but this will rarely be clear, and may be regarded as an interpretation no longer open under Article 13 where there is a specific provision on indirect transfers, because of the presence of paragraph 3. This reflects the common legal principle that specific coverage with limitations implies that a more general coverage is not intended. In contrast, where a domestic anti-abuse rule recharacterizes an indirect transfer of an immovable property as a direct transfer of the same, paragraph 1 directly applies, as long as such domestic anti-abuse rule is not in violation of applicable tax treaties.
- **Paragraph 2** would not apply, as the shares sold are not effectively connected to the permanent establishment, comprised by the extractive facility.
- **Paragraph 3** would obviously not apply, as it relates to ships and aircraft.
- **Paragraph 4** specifically applies to address indirect transfers of immovable property. The United Nations version of the paragraph differed until 2017 from the OECD version. Now the two provisions are the same, drawing drafting from both of the previous models. This paragraph (often referred to as the “land-rich entities provision”) is considered in more detail below.

## Box IV.6

**Capital Gains under the model tax conventions****Capital gains under the 2017 UN Model: Article 13**

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

4. Gains derived by a resident

of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least \_\_\_ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

**Capital gains under the 2017  
OECD Model: Article 13**

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) may be taxed in that other State.
3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these

shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

**Definition of “Immovable  
Property in Article 6 of the  
United Nations Model (and in  
the OECD Model):**

2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.

- **Paragraph 5** would only apply to shares in “land-rich” companies that are not covered under paragraph 4. However, the paragraph only applies to shares in a company resident in the country seeking to tax the transfer; in the illustrated indirect transfer, the company whose shares are transferred may have underlying interests in a mine or other facility but is itself located in another country, and it is not at all clear that paragraph 5 refers to the indirect transfer of interests in domestic companies, especially as paragraph 4 is explicit on the point.
- **Paragraph 6** merely confirms that unless the country where the extractive facility is located has a taxing right preserved by the preceding paragraphs, only the residence state of the seller of the shares can tax profits made, and that will usually be another country.

### ***Shaping an effective land-rich entities regime in domestic law and in article 13(4) of tax treaties***

The Final Report on Action 6 of the OECD/Group of Twenty (G20) Base Erosion and Profit Shifting (BEPS) Project considered the operation of Article 13(4) and drew upon aspects of the United Nations and OECD Model Conventions versions of that provision in its suggested changes to the OECD Model.<sup>161</sup> The 2017 update of that model included these changes:

4. Gains derived by a resident of a Contracting State from the alienation of shares ***or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived*** more than 50 per cent of their value directly or indirectly from immovable property, ***as defined in Article 6***, situated in ***that*** other State.

While much of this already reflects much of what is in the Commentaries to the United Nations and OECD Model Conventions, the importance of this provision, which largely came from developing country and

---

<sup>161</sup> OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6–2015 Final Report* (Paris, OECD Publishing, 2015), p.71–72. Available at <http://dx.doi.org/10.1787/9789264241695-en>.



United Nations Model Convention practice, is increasingly being recognized. The United Nations Committee of Experts on International Cooperation in Tax Matters (United Nations Tax Committee) began consideration of whether Article 13(4) could be clarified or improved as part of the 2017 update of the United Nations Model Convention. Eventually, the same text was adopted as under the OECD Model Convention.

There are many choices involved in relation to a specific indirect transfer provision in a tax treaty, and of course the results of those choices will have to be negotiated with other countries, many of which will have different views. The choices include

- (i) Whether to have a specific indirect transfers provision at all:
  - a. As noted above, unless there are domestic law provisions giving taxing rights or negotiators want to ensure that any such future legislation will not be rendered ineffective in a treaty relationship, there is little point in negotiating for a provision such as this where the other negotiating party does not seek it. The other side will almost inevitably seek some concession in return for a treaty provision that may not advance the policy interests and revenue base of the country;
  - b. The advantage of a specific provision is that there is a clear coverage of indirect transfers, unless there are court decisions on the coverage of indirect transfers under paragraph 1 in a country (something that is likely to be very rare). It reduces the risk of an interpretational difference between two countries that leads to both claiming competing taxing jurisdiction under paragraph 1, and possible unresolved double taxation. This could negatively impact the investment climate; and
  - c. A potential disadvantage of a special provision is that, because of what is specifically required before it can apply (noted in more detail below) it can reduce the likelihood of a purposive, anti-avoidance approach to paragraph 1 by the courts, and it can also serve as a (not easily amended) road map for tax avoidance by mitigating the effect of the specific requirements.

- (ii) Whether to have traditional wording as in the 2011 United Nations Model Convention (emphasis added)— “property of which *consists* directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State;” whether to use the pre-2017 OECD Model Convention wording— “Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other State may be taxed in that other State”; or whether, as in the 2017 version of both the UN and OECD model conventions, to specifically provide that the test need not be satisfied at time of transfer, but can be met at any time in the 365 days prior to the transfer. Some will see this as potentially unfair on the sellers (and potentially the buyers) while others will see it as a useful way of ensuring the proportion of value comprised by the property in the taxing state is not artificially “watered down” just prior to sale with a view to negating the provision’s operation. The United Nations Tax Committee has not yet decided on this point.
- (iii) Whether there should be an exception for immovable property used in an extractive business:
- a. The United Nations Model Convention until 2017 provided at paragraph 4(a) of Article 13 that:
 

Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities;<sup>162</sup>
  - b. It was not entirely clear what the central phrase “used ... in its business activities” meant. On one view, any holdings of mines and other facilities, as well as mining leases and other related immovable property leases

---

<sup>162</sup> 2017 United Nations Model Convention.

would inevitably fall outside the scope of the indirect transfer provision, as they are actively being used in business activities. On another view, however, more is required, since merely holding an asset, for example, is not a use in *one's own* (as a distinct legal entity) business activities. Further, the fact that Company A owns Company B (which holds a particular asset) does not mean that Company A is *using* Company B's asset in *its* (i.e., Company A's) business activities. In this view, there has to be direct active use, not just a passive holding. In other words, indirect holdings are explicitly addressed by this paragraph, but indirect use through the mining operator further down the chain is not treated as a *use* in the business activities of the company higher up the chain, perhaps several companies removed;

- c. The Commentary did not address the interpretation of this provision (added as part of the United Nations Model Convention as amended in 1999 and published in 2001) in any detail, but some support for the latter view could be found in the Commentary:

[Paragraph 4] is designed to prevent the avoidance of taxes on the gains from the transfer of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the transfer of shares in such a company (...) It also decided to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities;<sup>163</sup>

- d. On the other hand, those opposed to the latter interpretation would point out that the paragraph may have little meaning if it were the correct interpretation, as a company rarely if ever uses the assets of its subsidiaries in its operations itself. They would also point to the discussion of the same issue in the OECD Commentary at paragraph 28.7:

---

<sup>163</sup> Ibid.

Also, some States consider that the paragraph should not apply to gains (...) where the immovable property from which the shares or comparable interests derive their value is immovable property (such as a mine or a hotel) in which a business is carried on. States wishing to provide for one or more of these exceptions are free to do so.

- e. Paragraph 8.4 of the Commentary to the 2017 United Nations Model Convention provides:

In adopting the updated wording from the OECD Model Convention in 2017, the Committee decided to omit paragraph 4(a) from the United Nations Model Convention as it did not reflect common practice. It was found that the provision was very rarely used and was difficult to apply. However, countries may agree during bilateral negotiations to include the words from subparagraph (a) as it appeared prior to the 2017 update, at the end of paragraph 4, as follows: (...)

- (iv) Whether gains on such a transfer should be deemed to be sourced locally:
  - a. While some provision (such as Article 13(4)) is needed to *preserve* the taxing right in a tax treaty, the specific rule deeming such gains as locally sourced should be placed in domestic law. The treaty will not, in the view of most countries, provide a taxing right that does not exist in domestic law;
  - b. Where there is domestic legislation, it should provide that the gains made are sourced locally when the immovable property is located locally. The gains could be taxed or could be limited to the proportion of the gains that reflects the proportion of the value of shares sold corresponding to the proportion of local immovable property to other assets;
  - c. In tax treaty terms, the domestic legislation will not, of course, by itself ensure that the gain is treated as taxable in the country of the immovable property asset under the treaty, and require the treaty partner to, for example,

give credit for that tax paid. The treaty partner may, for example, regard the gain as sourced in its country and fully taxable under the treaty there, or as sourced in a third country. To avoid double taxation based on source (and double non-taxation, where a taxing right might be claimed by the treaty partner but not exercised) it is therefore important to consider specifically addressing such transfers in treaties, such as in some form of Article 13(4) provision which specifically allows the country of the asset a taxing right. Of itself, it will not prevent a third country with which no treaty exists from claiming source taxing rights under its own law.

- (v) Whether an indirect transfer provision should extend beyond transfers in shares:
  - a. If the indirect transfers provision is confined to the transfer of company shares, it would be easy to avoid it (such as by using a unit trust, and selling units), although this also may depend on the entity-classification rule of countries (for example, if trusts, partnership or estates are fiscally transparent and thus looked through, such an avoidance attempt may not be successful). The United Nations Model Convention was, thus, revised in 1999 (published in 2001) to extend the rule to trusts, partnerships and estates, although estates might not be relevant particularly to extractives. The OECD Model Convention had an option at paragraph 28.5 of the Commentary to cover “shares or comparable interests”. There seems to be increasing use of these sorts of extensions, and the OECD/G20, in its 2014 BEPS Deliverable on Action 6, recommended amending Article 13(4) to cover “shares or comparable interests, such as interests in a partnership or trust”. This is a clause blending the above United Nations and OECD Model provisions.<sup>164</sup> The Final

---

<sup>164</sup> OECD, “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable,” in *BEPS Action 6: 2014 Deliverable*, pp. 78–79. Available at <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-9789264219120-en.htm>. See also OECD, “Preventing the Granting of Treaty Benefits in Inappropriate

Report on Action 6 in October 2016 carried through this suggestion.<sup>165</sup> The 2017 Update of the OECD Model made this change. Some will prefer the option under the 2011 United Nations Model Convention, which does not depend on the concept of “comparable interests”, although the OECD Model Convention drafting seems designed to state that partnerships and trusts are de facto comparable interests, without the need to look at the domestic laws of one State or another. The 2011 United Nations Model Convention avoided any such issues, if they exist, but some may prefer the OECD Model Convention as allowing coverage of comparable interests even if they are not the partnerships, trusts or estates addressed specifically (and, it seems, as an exhaustive list) by the United Nations Model Convention. As noted, the 2017 United Nations Model Convention uses the same wording as the 2017 OECD Model Convention;

- b. The specific rule extending taxing rights beyond transfers of shares to cover other interests would need to be reflected *both* in the treaty provision preserving the taxing right and in the specific domestic legislation to ensure that the treaty right is implemented in practice.
- (vi) What valuation method should be used:
- a. Paragraph 4(b) of Article 13 of the United Nations Model provided until 2017 that “[f]or the purposes of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.” This was merely repeated in the Commentary on that article, without elaboration of how it is to be applied in practice;
  - b. The OECD Commentary on Article 13 provides at paragraph 28.4 that “paragraph 4 allows the taxation

---

Circumstances, Action 6—2015 Final Report”, in *BEPS Action 6: 2015 Final Report*, pp. 71–72. Available at <http://dx.doi.org/10.1787/9789264241695-en>.

<sup>165</sup> *Ibid*, p.72.

of the entire gain attributable to the shares to which it applies even where part of the value of the share is derived from property other than immovable property located in the source State”. The determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property). Paragraph 8.3 of the 2017 United Nations Model Convention’s Commentary takes the same approach;

- c. It seems that practice on whether countries use fair market value (reflecting current value in the market) or book value (reflecting the price initially paid) as the valuation method is very varied. Some countries have a blended requirement that allows the latter to be used in some circumstances unless there is any reason for a shareholder to suspect that it does not fully reflect the underlying value of the immovable property, as compared with other assets. Many, probably most, countries do not seem to include intangibles in the calculation, perhaps in part because of the difficulty of accurately calculating this. However, such interpretation might be problematic in countries where intangibles are treated as a “property” or “asset” under domestic laws, especially when they use fair market value as the valuation method, since sometimes the fair market value of intangibles can be significant, and exclusions of those intangibles may be regarded as overly broadening taxing rights of such countries contrary to the terms of the applicable treaties.
- (vii) Whether there should be an exception for shares quoted on a stock exchange:
- a. This is sometimes used as a mechanism to reduce compliance costs for taxpayers (and administration costs for tax authorities) in cases where there is a

genuine share market transaction, since there can be less tax-avoidance risk involved. It would usually be defined to include at least the stock exchanges of the two treaty countries, and in the case of domestic legislation operating even without a treaty, the legislating country's stock exchange(s). As regards stock exchanges in third countries, countries may not be willing to broadly cover all stock exchanges in any countries, and instead may want to confine coverage to certain reputable and reliable stock exchanges. In this regard, tax treaty practices in defining "recognized stock exchange" in limitation on benefits (LOB) clauses may serve as a useful reference. They typically either simply define the term as stock exchanges agreed between the competent authorities or else list certain stock exchanges, usually in the two countries as well as other stock exchanges agreed between the competent authorities.<sup>166</sup> Sometimes the term is used but left undefined<sup>167</sup> and sometimes it may list stock exchanges in countries with which either of two treaty countries have strong economic connections (such as regional stock exchanges or a major international stock exchange).<sup>168</sup>

- b. The specific exception for such on-market transfers would only need to be reflected in the domestic legislation if there is a taxing right such as under Article 13(4) since it narrows rather than extends the treaty right. For example, Public Notice 7 of China, although an administrative regulation, exempts transactions through public securities markets. In contrast, Japan sets a higher threshold for percentage of shares that needs to be held by the transferor in the case of listed shares, which is 5 per cent, as opposed to 2 per cent for the other shares;<sup>169</sup> this can also be seen as one variety of this exception. The

---

<sup>166</sup> Costa Rica-Mexico Double Tax Treaty (2014) Article 24 (4).

<sup>167</sup> Singapore-Sri Lanka Double Tax Treaty (2014) Article 14(4).

<sup>168</sup> Ethiopia-Netherlands Double Tax Agreement (2012) Article 3(1).

<sup>169</sup> Edwin T. Whatley and Shinichi Kobayashi, "Taxation of Indirect Equity Transfers: Japan", in *17 Asia-Pacific Tax Bulletin*, 2 (2011) p. 138.



United States also has a 5 per cent threshold for the same percentages, which is only applicable to listed shares.

(vii) Should there be a reorganizations clause?

In paragraph 28.7 of the OECD Model Convention Commentary to article 13.4 it is noted (emphasis added) that:

[a]lso, some States consider that the paragraph should not apply to gains derived from the alienation of shares of companies that are listed on an approved stock exchange of one of the States, *to gains derived from the alienation of shares in the course of a corporate reorganization* or where the immovable property from which the shares derive their value is immovable property (such as a mine or a hotel) in which a business is carried on. States wishing to provide for one or more of these exceptions are free to do so.

The rationale behind this type of provision is not to grant an exemption for such transactions, but simply to neutralize, by means of a deferral system, the taxation on the unrealized gains existing at the time the reorganization takes place, and to therefore not discourage more efficient capital allocation. Those not providing such a special treatment in domestic law and in treaties may be concerned about possible abuses. The pros and cons of such domestic law and treaty provisions should both be considered when addressing this policy issue. If it is included in a treaty, its scope of operation, including its relationship to anti-avoidance rules, should be discussed between the negotiating parties.

Examples of such a clause are included in the following treaties:

**Article 13.4 of the Belgium-Democratic Republic of the Congo Double Tax Treaty (2007)**

Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value from immovable property situated in the other Contracting State may be taxed in that other State. This paragraph shall not, however, apply to gains derived from the alienation:

- (a) of shares listed on a recognized stock exchange of a Contracting State, or
- (b) of shares sold or exchanged in the framework of a corporate reorganization, of a merger, of a division or of another similar operation, or
- (c) of shares deriving more than 50% of their value from immovable property in which the company exercises its activities, or
- (d) of shares owned by a person who holds directly or indirectly less than 25% of the capital of the company whose shares are alienated.

**Article 14.4 of the Hong-Kong—Malaysia Double Tax Treaty (2012)**

Gains derived by a resident of a Contracting Party from the alienation of shares of a company deriving more than fifty (50) per cent of its asset value directly or indirectly from immovable property situated in the other Contracting Party may be taxed in that other Party. However, this paragraph does not apply to gains derived from the alienation of shares:

- (a) quoted on such stock exchange as may be agreed between the Parties; or
- (b) alienated or exchanged in the framework of a reorganization of a company, a merger, a scission or a similar operation; or
- (c) in a company deriving more than fifty (50) per cent of its asset value from immovable property in which it carries on its business.

Before 2003 reorganization clauses were not so relevant, however some countries had taken them into account:

**Protocol to the Treaty between Spain and Mexico (1992)**

- 8.(a) With respect to paragraph 3 of Article 13,<sup>170</sup> gains

---

<sup>170</sup> Paragraph 3 states: “Gains from the alienation of shares that represent a participation of at least 25 per cent of the capital of a company resident of

derived from the alienation of shares in a company that is a resident of Mexico shall be determined without including capital contributions made during the period in which the shares are held and the profits accrued during the same period on which the issuing company has already paid income tax.

- (a) The tax charged, under paragraph 3 of Article 13, in the State of residence of the company the shares of which are alienated shall not exceed 25 per cent of the taxable gains.
  - (b) Where, owing to a reorganization of companies which are owned by the same group of shareholders, a resident of a Contracting State alienates property as a consequence of a merger or division of companies or an exchange of shares, then the recognition of the gain arising on the alienation of such property shall be deferred, for purposes of the income tax in the other Contracting State, to the moment in which a subsequent alienation which does not meet the requirements provided for in this paragraph for the deferment of the gains is affected.
- (viii) What should be the percentage of the gain taxed?

The provisions in the United Nations and OECD Models Conventions allow, when the company meets the requisite test for domestic immovable property holdings, for taxing of the whole gain, not just the percentage of it relating to immovable property in the taxing jurisdiction, but some countries provide a moderating effect in their domestic laws so that only that percentage is taxed.

- (ix) How can abuses be addressed within Article 13(4):
  - a. Some countries provide that the gain will be taxable if the percentage test for immovable property was met at any time in the year before transfer. This is to prevent manipulation of indirect assets held temporarily when the transfer occurs. In fact, the OECD 2014 BEPS

---

a Contracting State and held during at least the 12-month period preceding such alienation, may be taxed in that State.”

Deliverable on Action 6 notes this issue and gave a drafting suggestion which was reaffirmed in the Final Report on Action 6, as follows:<sup>171</sup>

32. Article 13(4) allows the Contracting State in which immovable property is situated to tax capital gains realized by a resident of the other State on shares of companies that derive more than 50 per cent of their value from such immovable property.

33. [omitted]

34. There might also be cases, however, where assets are contributed to an entity shortly before the transfer of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. In order to address such cases, it was agreed that Article 13(4) should be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only.

35. The following revised version of paragraph 4 of Article 13 incorporates these changes:

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived ~~deriving~~ more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that ~~the other State may be taxed in that other State.~~

(b) The question has sometimes arisen about whether Article 13(4) may still apply if the company holding

---

<sup>171</sup> OECD, BEPS Action 6: 2014 Deliverable, pp. 78–79; cf. BEPS Action 6: 2015 Final Report, pp. 71–72.

the immovable property borrows money just before the share transfer to dilute the percentage of assets constituted by immovable property. Some countries take the view that, as the OECD Commentary states at paragraph 28.4, debt should not be taken into account in the valuation of the property of the company, that the money borrowed should not be taken into account to dilute the percentage of immovable property interests. Other countries more specifically address this, as many do not see the implication as flowing necessarily from the OECD Commentary. In any case, this part of the OECD Commentary is not quoted in the United Nations Model Convention Commentary.

- (x) What are the possibilities for limiting the compliance difficulties in taxing capital gains?
  - a. One of the difficulties is that of how a shareholder will know if the test of indirectly held immovable property subject to taxation on indirect transfers has been met in a particular country. As it is often not clear whether the information could be effectively requested from the company, especially at a particular point in time, and as knowledge of immovable property held is not enough, the taxpayer would need to know where it is held. Even access to balance sheets may not indicate all of the assets of a company, or whether they are properly classed as “immovable” under relevant legislation. For these sorts of reasons, a number of countries such as Australia (10 per cent) and the United States (5 per cent, but only for listed shares) have *de minimis* standards in their domestic law so that small shareholders (portfolio investors) are not burdened by this requirement. South Africa has a 20 per cent threshold test for the taxpayer and related parties’ total holdings. These sorts of provisions may be especially relevant in the case of non-corporate vehicles, where less information is usually publicly available, although controlling interests may be more common.
  - b. As noted above, some countries, such as China, do not apply the laws of the countries where the shares are

openly traded on certain stock exchanges (e.g., those in the treaty countries) thus reducing compliance and administration costs.

- c. South Africa only applies its legislation to non-residents where 80 per cent or more of the market value of the holdings (shares, in the case of a company) derives from South African immovable property (otherwise held as trading stock) and where the non-resident (together with related parties) holds directly or indirectly 20 per cent or more of the shares in the company or ownership or right to ownership of another entity.
- d. What percentage is appropriate as applicable to the extractive industries would have to be determined, by also taking into consideration the practice in the industry. For example, if the industry practice is basically that one single investor wholly or substantially owns one mine, setting a high threshold percentage would still work in terms of effectively taxing indirect transfer of extractives. If, in contrast, it is the industry practice that several different investors sometimes invest in the same mine by setting up a joint venture, and that they transfer their interest to or among third parties, a high threshold percentage may not suffice. Treatment of farm-out and farm-in agreements may also have to be examined in this context.
- e. Recognizing that the percentage of assets may vary over time, some countries allow shareholders to take the proportions from the most recent accounts (i.e., not on the day of the transfer), unless they have reason to believe that those most recent accounts will not reflect the reality on the day of transfer. Malaysia, for example, allows the taxpayer to submit the audited accounts of the company for the financial year that is closest to the date of the transfer. In the United States, if there is a transfer between two balance sheet dates, the US corporation must nevertheless be able to demonstrate whether it is a U.S. Real Property Holding Company (the US legislative term for a “land-rich company”) on

the date of transfer. A US corporation can rely on the most recent balance sheet (i.e., quarterly, monthly, etc.) and determine whether there was a material shift in value or whether an additional relevant date was triggered in between the balance sheet date and the date of transfer by the foreign taxpayer.

- (xi) What is the importance of the domestic meaning of “immovable property”?
- a. Countries seeking to tax indirect transfers resulting in capital gains, and having treaty clauses similar to Article 13(4) need to take stock of their domestic law meaning of the term “immovable property”. This is especially important because the term “immovable property” is not defined in Article 13. This means that it either (i) looks to domestic law unless the context requires otherwise (in the terms of Article 3(2)) of both the United Nations and OECD Model Conventions; or else (ii) follows the definition in Article 6. The definition in Article 6 is not expressed (unlike the Article 3 definitions) to apply for the purposes of the Convention as a whole, but unlike the definitions of dividends, interest and royalties, it is also not expressed to apply only for the purposes of the Article (i.e., Article 6). Therefore, since there is a definition of immovable property in article 6 that is not explicitly confined to article 6, the definition may be considered as a relevant part of the treaty context;
  - b. Most countries regard the Article 6 definition as applying to Article 13, by inference. This takes us back to the meaning in domestic law, but ensures that—whatever the domestic legislation says—“rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources” are covered by the definition;
  - c. To guard against an interpretation that the term “immovable property” takes its meaning from domestic law only, with no “supplementation” from the Article 6 definition, countries should consider either (i) making

specific reference to the Article 6 definition in Article 13; or (ii) reflecting the Article 6 definition coverage, as a minimum, in domestic law. The latter would be an easier option for many countries as they can make it unilaterally. Countries might also consider it helpful to specifically clarify, in domestic law, the tax treatment of rights relating to the mining/oil or gas production, including reconnaissance and/or exploration-related rights as well as the extraction (i.e., development) rights themselves, and possibly surveys and other non-public information pertaining to the immovable property. Rights granted by or on behalf of a government might be covered, and whether or not they are expressed to be licences or to be granted as part of licences.

- d. It should be noted that the reference is to the domestic law “meaning” of “immovable property” and, in some countries, it might not be considered necessary to specifically define “immovable property” because the meaning of the term is sufficiently clear. In contrast, as noted in box IV.9 below, Australia has legislated that the term “immovable property” encompasses the term “real property” more commonly used in Australian law.

Box IV.7

**The meaning of “immovable property” in South Africa<sup>a</sup>**

The capital gains tax provisions inter alia apply to the following assets of a person who is not a resident:

- Immovable property situated in the Republic held by that person;
- Any interest or right of whatever nature of that person to or in immovable property situated in the Republic; and
- Rights to variable or fixed payments as consideration for the working of or the right to work mineral deposits, sources and other natural resources.

An interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested interest of a person in any assets of any trust, if:



- (a) 80 per cent or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and
- (b) In the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person) directly or indirectly, holds at least 20 per cent of the equity shares in that company or ownership or right to ownership of that other entity.

**a** *South Africa's Income Tax Act 58 of 1962*, Eighth Schedule, paragraph 2. Available at [http://www.into-sa.com/uploads/download/file/12/Income\\_Tax\\_Act\\_\\_1962\\_.pdf](http://www.into-sa.com/uploads/download/file/12/Income_Tax_Act__1962_.pdf).

#### Box IV.8

#### **The meaning of “real property” in Australia <sup>a</sup>**

A capital gains tax asset is taxable Australian real property if it is:

- (a) Real property situated in Australia (including a lease of land, if the land is situated in Australia; or
- (b) a mining, quarrying or prospecting right (to the extent that the right is not real property) if the minerals, petroleum or quarry rights are situated in Australia.<sup>a</sup>

Note: The International Tax Agreements Amendment Bill 2014 was approved by the Australian Parliament on 24 September 2014. It clarifies that the term “immovable property” encompasses “real property” to the extent that an Australian treaty provides that immovable property has the same meaning it has under domestic law.

**a** *Australia's Income Tax Assessment Act 1997*, Section 855.20. Available at [http://www.austlii.edu.au/au/legis/cth/consol\\_act/itaa1997240/s855.20.html](http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1997240/s855.20.html).

#### Box IV.9

#### **The meaning of “immovable property” in India <sup>a</sup>**

India provides in its legislation that plant and fittings and “other things” transferred with a building are included in the broadly defined term “immovable property” as follows:

- (d) “immovable property” means -
  - (i) any land or any building or part of a building, and includes, where any land or any building or part of a building is to be transferred together with any machinery, plant, furniture, fittings or

other things, such machinery, plant, furniture, fittings or other things also.

Explanation. For the purposes of this sub-clause, “land, building, part of a building, machinery, plant, furniture, fittings and other things” include any rights therein;

- (ii) any rights in or with respect to any land or any building or a part of a building (whether or not including any machinery, plant, furniture, fittings or other things therein) which has been constructed or which is to be constructed, accruing or arising from any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement of whatever nature) not being a transaction by way of sale, exchange or lease of such land, building or part of a building.

- a** *Indian Income Tax Act, 1961-2014*, Section 269UA. Available at <http://www.lawzonline.com/bareacts/income-tax-act/section269UA-income-tax-act.htm>.

In a 2012 International Monetary Fund (IMF) Staff Technical Assistance Report on Mongolia, the IMF recommended that the definition of “immovable property” should specifically include depreciable assets used in the extractive operation:

40. Exploration and mining licences are typically regarded as immovable property; depreciable assets used in mining activities are not necessarily covered as such. If the double tax agreement (DTA) provision does not explicitly states that the value of such assets must be taken into account, part of the domestic taxing right is not safeguarded, and consequently a smaller part of the capital gains can be taxed in Mongolia. Under the DTAs with Canada and France it could be argued that the Mongolian domestic tax provision is safeguarded as an exploration or mining licence can be regarded as “rental property that is used by the taxpayer to carry on its business activities.”<sup>172</sup>

<sup>172</sup> International Monetary Fund, “Mongolia: Technical Assistance Report—Safeguarding Domestic Revenue—A Mongolian DTA Model”, in *IMF Country Report No. 12/306* (July 2012), paragraph 40. Available at <http://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf>.

Ultimately countries will need to ensure that they have a definition that is sufficiently broad to allow the full value of the immovable property to be taxed and makes sense in the context of their domestic law (the concept of “fixtures” can be a very complex one that may be alien to a country’s jurisprudence, for example). No less important, the legislation should be consistent with an interpretation resulting from the obligation to interpret the treaty in good faith (see Article 31 of the *Vienna Convention on the Law of Treaties*,<sup>173</sup> regarded as reflecting customary international law).

Box IV.10

**IMF recommendations on the Philippines<sup>a</sup>**

**Transfers of exploration permits, mining agreements, and interests in mining companies**

58. **The Mining Act allows for the assignment (transfer) of exploration permits to another person.** Gains realized on the transfer of an exploration permit or mining agreement are subject to income tax as business income or capital gains, most likely as capital gains since a mining company will not hold permits as inventory. Any gain realized on the transfer by a company of an exploration permit or mining agreement will thus likely be subject to 30 per cent tax. In contrast, if mining rights are held indirectly through an interposed company, the increased value of the rights could be realized by way of a sale of shares in the interposed company with the tax rate on this gain being 10 per cent.

59. A non-resident company is liable to tax on gains realized on the sales of real property in the Philippines and sales of shares in a Philippine company as both are treated as Philippine-source income wherever the sale may be completed. There is no specific rule for mining interests, however, and a sale of mining interests by a non-resident might be able to escape tax if sold directly and almost certainly would escape tax if it were sold indirectly by way of a sale of shares in a foreign upper tier company that owned a Philippine company that owned the mining interests. A solution to this problem commonly used elsewhere is to expand the definition of real property for income tax purposes to include any mining interests or any interests in any trust, company, partnership or any other entity or arrangement where at least 50 per cent of the value of the interest is attributable to direct or indirect interests in real property (included deemed

<sup>173</sup> United Nations, Treaty Series, vol. 1155, p. 331.

real property in the form of mining rights). If this rule were adopted, gains from the sale of shares in companies that directly or indirectly owned mining rights would be taxed at 30 per cent as gains from the sale of real property rather than at 10 per cent as gains from the sale of shares.

60. Unfortunately, Philippines has entered into a number of tax treaties that require it to give up its right to tax residents of the treaty partner country on gains from the sale of mining rights where those rights are held via a small chain of companies. The Philippines has a very extensive tax treaty network and it will be almost impossible to renegotiate the treaties to extend Philippines taxing rights over gains related to Philippine mining interests. However, future treaties should adopt a broad definition of real property for purposes of the capital gains article to include all direct and indirect interests in mining rights. If there are opportunities to amend existing treaties, these should be used to address the definition of real property in existing treaties.

61. Philippines authorities currently have no direct enforcement powers over non-residents with respect to collection of income tax on gains from direct or indirect sale of Philippine mining rights. However, it is likely that Philippine authorities only learn of any indirect transfers of Philippine mining rights (i.e., selling of interest in the company that owned the company with the mining rights) through international mining industry information channels and not through any government data collection. A simple enforcement mechanism to ensure collection of tax on both direct and indirect sales would be to provide an automatic security interest for the [Bureau of Internal Revenue] in respect of any unpaid tax on gains on the direct or indirect sale of mining interests. If this rule were in place, the parties to the transaction itself would ensure tax is paid to protect the interest of the buyer and the sale price of the seller.

62. An alternative approach that the authorities may want to consider would be taxing the deemed gain of the local company holding the mining rights. Under this approach, if there is a five or 10 per cent or more change in the underlying ownership of the entity holding the mining right, the entity is treated as: (1) disposing of its proportionate interest in its mining right and immediately re-acquiring that interest; (2) receiving for the disposal consideration equal to the market value of the proportion of the mining right treated as disposed of; and (3) incurring a cost in respect of the re-acquisition of an equal amount.

- a** International Monetary Fund, “Philippines: Reform of the Fiscal Regimes for Mining and Petroleum”, in *IMF Country Report No. 12/219* (Washington, D.C., IMF, 2012), p. 29-30.

Box IV.11

**A case in point: Peru**

**Taxing transfer of shares in “land-rich” companies**

By Law No. 29663 of 15 February 2011, capital gains of non-residents of Peru from the indirect transfer of ownership or participation in Peruvian companies is treated as sourced in Peru and taxable in Peru.

The indirect transfer is deemed to occur if shares from a non-resident company are transferred and that company owns shares of a resident company, directly or through other companies, as long as (i) over the 12 months prior to disposal the market value of the domiciled company’s shares held by the non-domiciled company directly or through other companies equals 50 per cent or more of the market value of shares of the non-domiciled entity; or (ii) the non-domiciled entity resides in a low-tax jurisdiction.

Peruvian resident companies must report any indirect transfers to the Peruvian Tax Administration by foreign affiliates. If the transferor is not a resident, the domestic company will be jointly and severally liable for any capital gains tax arising from the indirect transfer.

There was criticism that very small transactions would be caught by the legislation, provided that the transfer resulted in a capital gain for a non-resident company owning the shares.

In July of 2011, Law No. 29757 provided some relief. An indirect transfer would only be taxable if the transaction represented a transfer of 10 per cent or more of the non-resident company’s interest in its investment in Peru. The 10 per cent threshold is determined by amalgamating any disposals over a 12-month period (to reduce the chances of transfers done little by little over a 12-month period).

Law No. 29757 also addressed issues of the *amount* of the taxable capital gain. In general, the basis of shares acquired before the 16 February 2011 effective date of Law No. 29663 would be the greater of (i) the market value of the shares as of 15 February 2011; or (ii) the acquisition cost or the value of the equity if acquired without consideration. Market value, if the shares were listed on a stock exchange, would be the stock exchange price at the close of February 15, 2011, or the last published quotation.

For shares not listed on a stock exchange, the value of the shares at the time when they were added to the company’s balance sheet is used, based on an audited balance sheet of the non-resident company. The balance sheet could not be dated earlier than 15 February 2010.

Other changes included in Law No. 29757 were new provisions that:

- (i) Limited the deemed Peruvian sourced income to the proportion of the value of the shares sold which represents the indirect Peruvian interests (i.e., the gain on the shares as a whole would not be taxed *where part of the value relates to unrelated investments*); and
- (ii) *Considered those who were paying or crediting income as a result of the indirect transfer of shares to be deemed withholding agents, and in such cases the company whose shares are indirectly sold is not jointly or severally liable.*

### **Other approaches for taxing indirect transfers in compliance with tax treaties**

There are at least two other approaches that can effectively tax indirect transfers without violating tax treaties. First is the use of a GAAR in domestic tax law that recharacterizes, for domestic tax law purposes, an indirect transfer of shares in a domestic corporation as a direct transfer of the same, where only the latter is taxable under the domestic tax law. For example, Public Notice 7 of China is based on a GAAR in its domestic tax law and recharacterizes an indirect transfer as a direct transfer in certain circumstances (see boxes IV.12 and IV.12A below for more details). Under this approach, countries can effectively tax indirect transfers, regardless of the proportion of values in shares that are derived from immovable properties. Countries that want to tax indirect transfers even in non-extractive industries may prefer this approach for the following reasons:

- (i) As regards the relationship with tax treaties, if such recharacterization under the domestic tax law is respected for tax treaty purposes as well, Article 13(5) of the United Nations Model Convention will, to the extent permitted thereunder, authorize taxing rights to the country seeking to tax the transfer. As regards GAARs, paragraphs 22 and 22.1 of the OECD Commentary states as follows (*emphasis added*):

22. Other forms of abuse of tax treaties (e.g., the use of a base company) and possible ways to deal with them, including “substance-over-form,” “economic substance” and *general anti-abuse rules* have also been analysed,

particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above.

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, ***there will be no conflict***. For example, to the extent that the application of the rules referred to in paragraph 22 results in a recharacterization of income or in a redetermination of the taxpayer who is considered to derive such income, ***the provisions of the Convention will be applied taking into account these changes***.

- (i) The guiding principles to qualify as a GAAR under the OECD Commentary are found in paragraph 9.5 of the Commentary on Article 1, being that:
  - (a) *a main purpose* for entering into certain transactions or arrangements was to secure a more favourable tax position; and
  - (b) obtaining that more favourable treatment in these circumstances would be *contrary to the object and purpose of the relevant provision*.
- (ii) OECD/G20 2014 BEPS Deliverable on Action 6 reinforced this position and states that if these conditions are satisfied, there would be no conflict with tax treaties; the Final Report on Action 6 reaffirmed this.<sup>174</sup> Paragraphs 20–27 of the United Nations Commentary on Article 1 basically follow the OECD Commentary.
- (iii) Hence, as long as the United Nations and OECD Commentaries are followed, and those guiding principles are satisfied, GAARs would be respected for tax treaty purposes.<sup>175</sup> Countries have to make sure that these

---

<sup>174</sup> OECD, BEPS Action 6: 2014 Deliverable, p. 92; cf. BEPS Action 6: 2015 Final Report, p. 79 ff.

<sup>175</sup> But see Qiguang Zhou, “The Relationship between China’s Tax Treaties and Indirect Transfer Anti-avoidance Rules”, in *74 Tax Notes*

principles are satisfied, and this would affect the scope of indirect transfers that can be covered by this approach. For example, in order for an indirect transfer to be considered abusive, it would be generally necessary that the percentage of shares transferred be sufficiently high. Furthermore, if countries desire to effectively tax the indirect transfer of shares in domestic corporations the sale of shares to related persons and sales over a period of time may need to be aggregated. Also, industry practices should be examined in order to decide on the level of an appropriate threshold percentage to effectively tax indirect transfers in the extractive industry.

- (iv) The determination of which circumstances satisfy such guiding principles can largely depend on how strictly the court in each country reviews the conformity of GAARs with those principles; establishing such conformity may be burdensome for tax administrations in some countries. In addition, this GAAR approach may be considered too uncertain for taxpayers due to the subjective standard to be used, particularly if one of the requirements is dependent on a future event (e.g., tax implications of a future transaction) and this may impede otherwise desirable business transactions. For these reasons, countries may prefer other approaches.

Where an indirect transfer of shares in a domestic corporation is successfully recharacterized as a direct transfer of the same, attention should be paid to the issue of potential double taxation. While, as a result of recharacterization, the transferor is treated as having directly transferred shares in a domestic corporation, it does not follow that the transferee is treated as directly acquiring and owning those shares for tax purposes in the future as well. As a matter of fact/form, the transferee owns the shares in the offshore holding company, which in turn owns the shares in a domestic corporation, and such fact/form can be respected in deciding the tax consequences in a future transaction. This can be problematic particularly when the offshore holding company sells the

---

*International*, 543 (May 2014), for its criticism of the OECD/United Nations interpretation as too general.



shares in the domestic corporation, since in this case, unless the GAAR (or relevant enforcement regulation thereunder) specifically addresses the issue of basis in the shares owned by the offshore holding company, double taxation can potentially arise. This is because the offshore holding company by itself neither owns newly-acquired shares in the domestic corporation nor paid taxes for the transfer in the first transaction, and hence, its basis in the shares may be treated as unchanged, despite the fact that taxes for built-in gains in those shares are effectively already paid by the former shareholder of the offshore holding company. It appears theoretically consistent to give the offshore holding company a stepped-up basis in the shares; however, since a GAAR would be generally triggered only in abusive cases under the aforementioned guiding principles, some countries may not be willing to do so.

Box IV.12A

**A case in point: China**

**General anti-abuse rule, with specific enforcement regulation for indirect transfer**

Under Article 47 of the Corporate Income Tax Law of China, introduced in 2008, if taxable income is reduced as a result of arrangements with no reasonable commercial purpose, the tax authorities can make adjustments.

According to State Administration of Taxation Order 32, which was published in 2014 as a general administrative guidance on the application of Article 47, two major features of a tax avoidance arrangement are required to justify its denial under Article 47: (a) its sole or main purpose is to obtain tax benefit; and (b) its legal form is not commensurate with its economic substance.

Additionally, Public Notice 7 was released in 2015 as an enforcement regulation to specifically handle indirect transfers. This new regulation replaces previous rules under Circular 698, issued in 2009. Under Public Notice 7, an indirect transfer will be recharacterized as a direct transfer of China Taxable Property if the following requirements are *all* satisfied:

- (a) A non-resident entity transfers equity or other similar interests in an offshore holding entity that directly or indirectly holds China Taxable Property;
- (b) The result of the transfer is, in substance, the same as or similar to the direct transfer of the China Taxable Property;

- (c) The transfer is made by the non-resident entity through arrangements lacking reasonable commercial purpose; and
- (d) The non-resident entity avoids corporate income tax liability.

“China taxable Property” is defined as (a) property of an “establishment or place”—a domestic concept corresponding to a permanent establishment under treaties—in China; (b) real property in China; (c) equity interests in Chinese resident entities; and (d) other property directly held by a non-resident entity and the transfer of which brings about corporate income tax liability. This definition was expanded from the one in the Circular, under which only equity interests in Chinese resident entities were covered. In the case of (b) and (c) above, buyers owe obligations to withhold 10 per cent from the purchase price.

Box IV.12B

**A case in point: China—Public Notice 7 factors**

**General anti-abuse rule, with specific enforcement regulation for indirect transfer**

Public Notice 7 lists the following as factors to be taken into consideration for the purpose of determining the existence of “reasonable commercial purpose”:

- (a) Whether the value of the offshore holding entity’s equity is mainly directly or indirectly derived from China Taxable Property;
- (b) Whether the assets of the offshore holding entity mainly comprise direct or indirect investments in China, or whether the revenue of the offshore holding entity is mainly sourced directly or indirectly from China;
- (c) Actual functions performed by or actual risks assumed by the offshore holding entity and its affiliates holding directly or indirectly China Taxable Property is sufficient to prove economic substance
- (d) Duration of the offshore holding entity’s shareholders, business model and relevant organizational structures;
- (e) Tax implications of the indirect transfer outside of China;
- (f) Whether the investment and transfer of China Taxable Property could have been affected directly, as opposed to indirectly;
- (g) Applicable tax treaties or arrangements in China with respect to the indirect transfer; and
- (h) Other relevant factors.

The following three categories of transactions are exempted from the recharacterization: (a) intra-group reorganizations satisfying certain requirements; (b) gains that would have been exempt even in the case of a direct transfer; and (c) transactions through public stock exchanges. The categories (a) and (b) above are addressed by Public Notice 7, but not under Circular 698.

Public Notice 7 includes a provision for voluntary reporting of transactions to the tax authority by buyers, sellers and underlying Chinese entities. This is a change from Circular 698, where buyers were required to report transactions. If buyers report transactions, they are potentially entitled to exemption from, or reduction of, future penalties. If sellers report transactions, they can be exempted from additional annual 5 per cent punitive interest. Tax authorities are also specifically authorized to make information requests to buyers, sellers, underlying Chinese entities and advisers.

Another approach to effectively tax an indirect transfer is to impose tax on the underlying domestic corporation that holds immovable properties—instead of the shareholder who transferred the offshore holding company which, in turn, owns the underlying domestic corporation—by deeming all built-in gains in properties of such domestic corporation as realized when there is a change in its shareholding over a certain percentage. The built-in gains to be taxed can be limited to those derived from immovable properties, but countries can also choose to tax all of them. For example, the United Republic of Tanzania taxes an underlying domestic corporation for all of the built-in gains if its ownership changes more than 50 per cent (see box 14 below for more details). Countries that want to follow this second approach may consider the following:

- (i) Tax treaties are generally applicable to protect only non-residents from taxation. It may be arguable that this domestic legislation is effectively taxing capital gains that are protected under Article 13. However, countries generally have broad discretion as to how to structure realization events for capital gains under their domestic legislation. For example, some developed countries have a fair-market-value based taxation system for listed stock or other financial instruments that have a fair market value. Also, the amount of capital gains can be different between a

direct transfer and an indirect transfer since the bases in the assets can be different. Hence, this accelerated realization of built-in gains itself would unlikely cause a conflict with tax treaty obligations.

- (ii) Another tax treaty obligation that countries should pay careful attention to is Article 24 (Non-discrimination) of both the United Nations and OECD Model Conventions. Paragraph 3 forbids taxation of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State that is less favourable than the taxation levied on enterprises of that other State carrying on the same activities. Paragraph 3 *only* relates to the taxation on the permanent establishment itself, however.
- (iii) Paragraph 5 of Article 24 forbids giving less favourable treatment to a resident corporation owned by non-residents. Hence, if the domestic legislation under this approach is applicable only to domestic corporations owned by non-residents, it can be considered invalid by violating Article 24(5). In order to avoid this concern, countries subject to such treaty obligations would have to apply this regime regardless of whether shareholders are residents or non-residents.
- (iv) In contrast, paragraph 5 of the United Nations Commentary on Article 24 includes the following alternative provision of Article 24(5) which was developed as part of the 2001 version of that Model in consideration of the tax compliance problems arising from foreign ownership of domestic corporations in developing countries. It was designed to provide “that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises are treated alike” (emphasis added):

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected

requirements to which are subjected other similar enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, *by residents of third countries*.

- (v) Unlike Article 24(5) of the United Nations and OECD Model Conventions, only discrimination between non-residents is prohibited under this alternate provision. There are several treaties that adopt this or similar provisions,<sup>176</sup> and under those treaties, countries that have adopted this alternate provision in their tax treaties can limit the scope of domestic legislation under this approach to cases where foreign ownership is involved. The arguments for and against the alternative provision are addressed in paragraphs 5 to 7 of the United Nations Model Commentary on Article 24.

As long as a change in ownership over a specified percentage happens, this approach fully taxes built-in gains regardless of the percentage of shares transferred indirectly, and the amount of tax can be quite burdensome in light of the percentage of shares actually transferred. There are several options to mitigate this problem, which are not necessarily mutually exclusive:

- (i) First, as regards the minimum threshold percentage of shares that need to be transferred, countries may consider setting a relatively high percentage (e.g., 50 per cent in the United Republic of Tanzania or 20 per cent in South Africa, with, in the latter case, at least 80 per cent of the market value of the company's shares being attributable directly or indirectly to immovable property) as compared to those used for domestic legislation pursuant to Article 13(4) of

---

<sup>176</sup> See, for example, the Norway-Qatar Treaty, as well as several treaties signed by Kuwait and the United Arab Emirates (UAE). For example, Art. 26(3) of the Mongolia-UAE treaty states: "Enterprises of a Contracting State, the capital of which is wholly or partly owned or which is controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any obligations connected therewith which is other or more burdensome than the taxation and connected obligations to which other similar enterprises the capital of which is wholly is or partly owned or which is controlled directly or indirectly by one or more residents of any third state are or may be subjected."

the United Nations and OECD Model Conventions (e.g., 5 per cent for listed shares and two per cent for non-listed shares in Japan). Such higher threshold may not be sufficient to deal with indirect transfers where several different shareholders set up a consortium to jointly invest in one project, for example in order to diversify the risks involved, and only some of them indirectly transfer their ownership rights. Again, industry practice should be examined to determine an appropriate threshold percentage.

- (ii) Alternatively, countries may choose to deem built-in gains as realized only to the extent corresponding to the percentage of shares transferred, although this can make the rule too complicated for both tax administrations and taxpayers.
- (iii) Another option is to deem not only built-in gains but also built-in losses as realized, and thereby, reduce the net taxable gains. In order to prevent attempts to avoid taxes by accelerating loss realization, countries may want to limit such deemed loss realization to the extent not exceeding the amount of gains deemed realized.

While this approach would make it easier for a tax administration to actually collect taxes, since the taxpayer is a domestic corporation located within its jurisdiction, it can at the same time cause a cash flow problem. The domestic corporation will need to finance the taxes due, even though the corporation itself does not receive any cash or other consideration for the transfer. In some cases, the domestic corporation may be obliged to dispose of some of its assets only to pay taxes, and this can ruin the business rationale of the transaction. In practice, this problem can be avoided if the transferor and transferee agree to reduce the consideration for the share transfer to the extent of taxes due on the domestic corporation and, after the transfer, the transferee contributes cash to the domestic corporation so that it can pay taxes. However, this practical solution may not always work, particularly when less than 100 per cent of the total shares in the domestic corporation are indirectly transferred, in which case the transferor would not be willing to bear all of the tax burden in the form of reduction in consideration it is entitled to.

Double taxation can also arise under this approach, and it can be more problematic here than other approaches. Under this approach, Article 24(5) of the United Nations and OECD Model Conventions

would require domestic tax laws to cover domestic corporations owned by residents. As a result, where a resident transfers shares in a domestic corporation, and the requirements for deemed gain recognition are satisfied, both the domestic shareholder and the underlying domestic corporation would have to realize gains immediately. This is different from other approaches where double taxation potentially arises only when the relevant shares/assets are transferred in the future. One solution would be to grant the shareholder a tax credit equivalent to the amount of taxes paid by the underlying domestic corporation as a result of the deemed gain recognition.

Box IV.13

**A case in point: The United Republic of Tanzania (deemed realization of gains by the underlying entity whose shares are indirectly transferred)<sup>a</sup>**

Under the Income Tax Act of the United Republic of Tanzania, an entity will be deemed to have realized gains in its assets, if its ownership changes, directly or indirectly, by more than 50 per cent (change of control) during a three-year period. As a result, if the underlying entity is a *resident*, it has to pay taxes for all of the gains deemed as realized, while a *non-resident* underlying entity is liable for taxes only to the extent derived from “domestic assets,” including immovable properties in the United Republic of Tanzania.

This regime effectively triggers taxation by the Government, where domestic assets in the United Republic of Tanzania are indirectly transferred through transfer of shares in an offshore holding entity. One distinct aspect of this regime as contrasted with the Peruvian approach above is that the underlying entity, not the shareholder who transferred its shares, is treated as realizing gains and thus liable for taxes. This unique nature was introduced by an amendment to the Income Tax Act in 2012. Before this amendment, the transferor, not the underlying entity, had been the taxpayer, and reducing enforcement difficulties and practical challenges by making the underlying entity directly liable for taxes appears to have been the main purpose of this amendment.

The Tanzanian Income Tax Act intentionally has no exemption for intra-group reorganizations, apparently due to concerns about potentially significant tax avoidance risks.

<sup>a</sup> Mr. Charles Bajungu, *Capital gains and taxation in indirect sales: experience, challenges and remedial efforts in Tanzanian perspective* (paper presented at the meeting of the Tanzania Revenue Authority and the United Nations Tax Committee, New York, October 2014). Available at [http://www.un.org/esa/ffd/wp-content/uploads/2014/11/10STM\\_PresentationBajungu.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/11/10STM_PresentationBajungu.pdf).

*Issues of identification*

The first issue is how does one even know about the indirect transfer, especially a transfer effected in a foreign jurisdiction (as it often will be)?

- (i) It is possible that information may come to light in an automatic exchange of information (although developing countries at this stage do not have many such arrangements) or by a spontaneous exchange from another country, but this is not likely to happen often either. Where treaty relationships exist, information could be sought from treaty partners, but that would usually only happen after there was an initial awareness of the transfer, and at least some of its details.
- (ii) Officers in the revenue collection agency should keep up to date with industry news and conduct regular Internet searches for sets of key words such as the names of mines, the word “mine,” and the country name have some value, but are necessarily to some extent reliant on chance to make discoveries of indirect transfers. Commercial databases may assist as might details of foreign takeovers required to be announced under domestic law or notifications of changes required under extractives legislation. In one case in China, a public announcement was found on the website of the buyer, announcing the completion of the acquisition of the Chinese company, but without mention of the intermediate holding company, a Hong Kong special purpose vehicle with little substance.<sup>177</sup> Changes in auditors may also sometimes reflect wider developments.
- (iii) Intelligence on developments in the extractive industries, internationally as well as domestically, will often first come to the attention of the resources ministry or some other investment-related ministry. There should be clear reporting arrangements between such ministries and the

---

<sup>177</sup> Cadwalader, Wickersham and Taft LLP, *Circular 698: China’s Anti-Tax Avoidance Measures for Offshore SPVs* (August 2010). Available at <http://www.lexology.com/library/detail.aspx?g=80bb2c3b-c408-4d9a-8880-86f49c8d6fdd>.



- tax authority on changes in ownership, contractors, other rights holders and the like, matched by strong reporting arrangements within the various parts of the tax authority.
- (iv) Other potential pointers to an indirect transfer might include changes in enterprise names, changes in directors and changes in tax auditors.<sup>178</sup> It has been noted that companies that have been listed on international stock exchanges subsequent to structuring are more prone to detection, and that accountants may be required to “provision” for a potential tax liability of the selling entity.<sup>179</sup>
  - (v) Some countries have imposed reporting obligations (i) on underlying domestic companies to report to authorities when they are indirectly sold or where there are major changes in their shareholding; or (ii) on shareholders of such companies (usually only those in a control situation—because the requirements can cast heavy obligations on the shareholder to know what business the company is conducting, and *might* present an issue of extraterritorial exercise of jurisdiction particularly when imposed too extensively) to report to authorities a transfer indirectly affecting local property. The fact that it is *only* a reporting obligation may be relevant in challenging claims of an extraterritorial exercise of jurisdiction, however.
  - (vi) To be effective, even requirements to notify major shareholding changes (of those above 10 per cent, for example) would need to provide coverage for multiple changes to shareholdings over a reasonable period of time (12 months or longer in some cases) to prevent several transfers of 9 per cent in a short time span not having to be reported.
  - (vii) Further, reporting requirements on ownership of interests would need to apply at more than one level, to ensure that the reporting requirements are not avoided by having the changes occur further up a string of companies. The intention of such “indirect” transfers being covered would need to be clear in the legislation.

---

<sup>178</sup> Ibid.

<sup>179</sup> Ibid.

- (viii) Sometimes the approach has been taken that even despite the difficulties identifying indirect disposals, legislation should be put in place (including requiring the local entity to notify any changes of ownership over a certain threshold) that can “provide the administration with a legal arsenal allowing it to take transfers of this type into account when its oversight capacities have advanced”.<sup>180</sup>
- (ix) More recently, some countries have opted to attribute “joint and several” liability (i.e., each party being independently liable for the full extent of any breach) for the payment of the tax between the purchaser and the entity holding the mining rights. That has been the experience in Mozambique, after the introduction of the new Mining Tax law, which came into effect in early 2015.

## Box IV.14

**Mozambique Law No. 28/2014 (the new Mining Tax Law)**

On 23 September 2014, Mozambique introduced a new tax regime and incentives for the mining sector. Among other things, the new law established that mining rights are considered as immovable property (within the meaning of Article 13(4) of its bilateral tax treaties) and that all capital gains arising from the direct or indirect transfer of mining rights by non-resident entities, with or without permanent establishment in Mozambique, will be taxable at a fixed rate of 32 per cent. This capital gains tax shall become due and payable by the by the seller or transferor but the purchaser and the Mozambique entity holding the mining rights has several and joint liability for the payment of the tax. In the case of doubt on the price of the transaction, the tax authorities may refer to the best international practices to determine the price.

The law sets out specific rules relating to the calculation of gains, taxable income, deductible costs and amortization in the framework of mining activities, rules that were previously established under the different concession agreements.

---

<sup>180</sup> International Monetary Fund, “Mali Technical Assistance Report—Mining and Petroleum Taxation (Diagnostic Assessment)”, in *IMF Country Report No. 15/348*, (December 2015) paragraph 131. Available at <https://www.imf.org/external/pubs/ft/scr/2015/cr15348.pdf>.

Box IV.15

**Viet Nam Ministry of Finance Circular No. 36/2016/TT-BTC dated February 26th, 2016<sup>a</sup>**

**Article 21. Subjects of tax**

1. The transfer of interests from participation in petroleum contract is that the organizations or individuals sell, transfer their investment capital (including the property and money) in petroleum contract, petroleum enterprises or joint venture enterprises in Vietnam, transfer the ownership, change the ownership or control right of one contractor party or determine by other ways the whole or a part of rights, interests and obligations in the petroleum contract, petroleum enterprises or joint venture enterprises (the transferor) for one or many organizations or individuals (the transferee) except for the financial restructuring or arrangement of the transferor or consolidation of the transferor's parent company. The transferee has the contractor's obligations and interests to conduct the search, exploration and extraction of oil and gas.

Where the enterprise established in foreign country (hereafter referred to as foreign enterprise) transfers its shares or investment capital (including the property or money) or other interests in an enterprise established in foreign country but the enterprise whose capital is transferred holds directly or indirectly the property and interests of participation in petroleum projects in Vietnam leading to the change of contractor's owner who are holding the interests of participation in petroleum projects in Vietnam. This transfer is also regarded as the transfer of interests of participation in petroleum contract. The foreign enterprise carrying out the above transfer is regarded as the transferor. (...)

**Article 23. Declaration and payment of corporate income tax for income from the transfer of interests of participation in the petroleum contract**

- *The transferor of interests of participation in the petroleum contract must make declaration and pay tax for the income from the transfer of interests of participation in the petroleum contract.*

1. Where the transfer changes the contractor's owner who is holding the interests of participation in the petroleum contract in Vietnam, the contractor named in the petroleum contract in Vietnam must inform the tax agency upon generation of transfer and make declaration and payment of tax on behalf of the transferor for the generated income pertaining to the petroleum contract in Vietnam in accordance with regulations.

2. The dossier of tax declaration for income from transfer of interests of participation in the petroleum contract:

The Declaration of corporate income tax on transfer of interests of participation in the petroleum contract is the Form No. 03/TNDN-DK issued with this Circular.

- *A copy of transfer contract (English copy and the Vietnamese translation);*
- *Certification of the operators, joint operating companies, parties involved in joint venture enterprises, Vietnam Oil and Gas Group on the total expenses incurred by the transferor in proportion to the prime price of the transferor's transferred interests and the evidencing documents;*
- *The original documents of expenses pertaining to the transfer transaction;*
- *Where the transfer changes the contractor's owner who is holding the interests of participation in the petroleum contract in Vietnam, the foreign contractor directly involved in the petroleum contract in Vietnam must make report and provide the additional documents as follows:*
  - The shareholding structure of the company before and after the transfer.
  - The financial statement of two years of foreign enterprises and their subsidiaries/branches directly or indirectly holding the interests of participation in the petroleum contract in Vietnam.
  - The report on valuation of property and other evaluating documents used to determine the value of transfer of stocks and foreign investment capital under contract.
  - The report on reality of income tax payment of foreign enterprise pertaining to the transfer leading to the change of contractor's owner who is holding the interests of participation in the petroleum contract in Vietnam.
  - The report on relationship between the transferring foreign enterprise and the branches/subsidiaries directly or indirectly holding the interests of participation in the petroleum contract in Vietnam on: contributed capital, business and production, revenues, expenses, accounts, assets, personnel...
  - In case of required addition of dossier, the tax agency shall inform the taxpayers within three working days from the date of receipt of dossier.

**a** Hệ thống pháp luật Việt Nam. See <https://vanbanphapluat.co/circular-no-36-2016-tt-btc-tax-conducting-the-search-exploration-extraction-oil-gas>.

Box IV.16

**India Ministry of Finance Notification S.O. 2226 (E) of 28 June 2016 (extract)<sup>a</sup>**

3. In the said rules [the income Tax rules, 1962], after rule 114DA, following rule shall be inserted, namely:

“114DB. Information or documents to be furnished under section 285A.

(1) Every Indian concern referred to in section 285A shall, for the purposes of the said section, maintain and furnish the information and documents in accordance with this rule.

(2) The information shall be furnished in Form No. 49D electronically under digital signature to the Assessing Officer having jurisdiction over the Indian concern within a period of ninety days from the end of the financial year in which any transfer of the share of, or interest in, a company or entity incorporated outside India (hereafter referred to as “foreign company or entity”) referred to in Explanation 5 to clause (i) of sub-section (1) of section 9 has taken place: Provided that where the transaction in respect of the share or the interest has the effect of directly or indirectly transferring the rights of management or control in relation to the Indian concern, the information shall be furnished in the said Form within ninety days of the transaction.

(3) The Indian concern shall maintain the following along with its English translation, if the documents originally prepared are in foreign languages and produce the same when called upon to do so by any income-tax authority in the course of any proceeding to substantiate the information furnished under sub-rule (2) namely:

- (i) details of the immediate holding company or entity, intermediate holding company or companies or entity or entities and ultimate holding company or entity of the Indian concern;
- (ii) details of other entities in India of the group of which the Indian concern is a constituent;
- (iii) the holding structure of the shares of, or the interest in, the foreign company or entity before and after the transfer;
- (iv) any transfer contract or agreement entered into in respect of the share of, or interest in, any foreign company or entity that holds any asset in India through, or in, the Indian concern;

- (v) financial and accounting statements of the foreign company or entity which directly or indirectly holds the assets in India through, or in, the Indian concern for two years prior to the date of transfer of the share or interest;
  - (vi) information relating to the decision or implementation process of the overall arrangement of the transfer;
  - (vii) information in respect of the foreign company or entity and its subsidiaries, relating to, -
    - (a) the business operation;
    - (b) personnel;
    - (c) finance and properties;
    - (d) internal and external audit or the valuation report, if any, forming basis of the consideration in respect of share, or the interest;
  - (viii) the asset valuation report and other supporting evidence to determine the place of location of the share or interest being transferred;
  - (ix) the details of payment of tax outside India, which relates to the transfer of the share or interest;
  - (x) the valuation report in respect of Indian asset and total assets duly certified by a merchant banker or accountant with supporting evidence;
  - (xi) documents which are issued in connection with the transactions under the accounting practice followed.
- (6) The information and documents specified in sub-rule (3) shall be kept and maintained for a period of eight years from the end of relevant assessment year.

**a** India Ministry of Finance, Notification S.O. 2226(E) (2016). Available at <https://www.incometaxindia.gov.in/Communications/Notification/Notification552016.pdf>

### ***Enforcement issues***

If there is a taxable disposition, how can the tax debt be enforced in practice? The indirect transfer generally takes place outside the jurisdiction where the property (such as a mine) is located and usually neither the buyer nor the seller is a resident.

- (i) While both the United Nations and OECD Model Conventions now contain optional Assistance in the Collection of Tax Debt Articles for countries wanting to

provide for this in bilateral tax treaties, and there is a multilateral OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters on the subject, this is not something most developing countries have included in their bilateral or multilateral agreements.

- (ii) One approach taken has been to deem that, where there is a change in ownership of an underlying domestic corporation holding assets over a certain percentage (50 per cent in the United Republic of Tanzania as seen above; 10 per cent in the case of Peru, as also seen above) there has been a disposal and reacquisition of exploration and development rights by such underlying domestic corporation. This would lead to a domestic capital gain (the responsible taxpayer will have to be made clear) and countries can enforce against a resident taxpayer. Depending on the legislation, reapprovals might be required for exploration, production or export licences, for example (although such reapprovals may not be necessary, if deemed disposals and re-acquisitions are made only for tax purposes). Reapproval may be required after a set period of years, however. Requiring a reapproval of the exploration, production or export licences in the event of a change of underlying ownership might be one mechanism to ensure that the capital gains tax owed on the transaction has been paid to the government of the country where the exploration happens or from where export occurs. This would of course have impact in terms of the investment climate for such activities, and the relevant or otherwise applicable investment treaties would need to be considered. Some preapproval process may mitigate but will unlikely eliminate these concerns.
- (iii) Alternatives include “joint and several” liabilities of the seller and buyer for the tax debt, or else a tax obligation on the indirect buyer of the assets (such as withholding obligation to withhold a specified percentage from the purchase price, which may or may not be sufficient to cover all taxes due on the seller). In the 2014 IMF’s Mali Technical Assistance Report, when addressing that country’s extractive legislation, the IMF noted that (after proposing an

indirect transfers treaty provision that unusually focused on Article 13(5) of the United Nations Model—dealing with transfer of shares) rather than Article 13(4):

**[f]or tax collection purposes, provisions could be made for the establishment of a withholding mechanism to ensure that taxes are collected.** A company established in Mali, whose rights are being directly or indirectly transferred, should withhold the amount of tax on capital gains realized abroad on the direct or indirect transfer of its rights. The new mechanism should be inserted in the form of an article in the General Tax Code. For reasons of simplicity, in the event that this tax is withheld at source when the transferring company is a non-resident, the mission suggests that the capital gain realized not be included in the IS [corporate income tax] tax base. <sup>181</sup>

- (iv) The theory is that publicizing an indirect transfer regime will put the buyer (exercising due diligence) on notice so that the buyer takes necessary actions, for example, making sure that the seller pays or reimburses all the taxes due through an indemnity clause. <sup>182</sup> In those cases, where the underlying domestic corporation becomes the taxpayer, the transfer price will reflect that. There may have to be legislation imposing obligations on the operator of, for example, a mine (such as in the capacity of as a withholding agent in respect of interest or dividends payable to shareholders/owners of the operating company) and imposing a specific lien upon the facility in the event of non-payment. In a case in Uganda, the revenue authority treated the buyer as the

---

<sup>181</sup> Ibid., paragraphs 130–132.

<sup>182</sup> The indemnity clause between a seller, Heritage Oil and Gas, and a buyer, Tullow Uganda, after the latter was treated as an agent by the Ugandan tax authorities was the subject of major litigation. See, for example, Alexander Keepin, Theo Jones, *M&A in emerging markets—don't lose value through the tax indemnity; lessons to learn from Tullow Uganda v Heritage Oil and Gas* (Berwin, Leighton, Paisner, August 2014). Available at <http://www.blplaw.com/expert-legal-insights/articles/ma-in-emerging-markets>.



agent for the seller because it was a signatory on an escrow account put aside by the seller for possible tax liabilities, even though the seller disputed the liability, and issued an “agency notice” to pay taxes due on the buyer.<sup>183</sup>

- (v) One alternative is allowing non-payment by a certain time after the payment becomes due to be a factor in denying export licences for the minerals, oil, or gas produced by the facility. This sort of provision is a very serious step, and it would need to preserve normal taxpayer rights under domestic law for contesting a tax debt. Its impact on any other owners of the mine or oil and gas facility whose interests were not transferred should also be borne in mind.
- (vi) However, this sort of response may not be possible (or only with the risk of substantial damages) because of contractual obligations, including stability (or “stabilization”) clauses that essentially freeze the applicable law for the life of the project or reimburse for costs resulting from regulatory change or because of governing Investment Protection Agreements with Fair and Equitable Treatment<sup>184</sup> or Umbrella clauses,<sup>185</sup> for example. Any consideration of a regime to address indirect transfers and any risks in

---

<sup>183</sup> Ibid.; see also on this specific point: Alexander Keepin and Theo Jones, *The deal risks of a disputed tax bill: Tullow Uganda v Heritage Oil and Gas* (Berwin, Leighton, Paisner, September 2013). Available at <http://www.blplaw.com/expert-legal-insights/articles/the-deal-risks-of-a-disputed-tax-bill-tullow-uganda-v-heritage-oil-and-gas>.

<sup>184</sup> See, for example, *United Nations Conference on Trade and Development, Fair and Equitable Treatment. UNCTAD Series on Issues in International Investment Agreements II* (New York, United Nations, 2012). Available at [http://unctad.org/en/Docs/unctaddiaeia2011d5\\_en.pdf](http://unctad.org/en/Docs/unctaddiaeia2011d5_en.pdf).

<sup>185</sup> Umbrella clauses meaning “[e]ach Contracting Party shall observe any obligation it may have assumed with regard to investments”, which gives an additional treaty basis to claims that contractual terms have not been abided. See, for example, Katia Yannaca-Small, “Interpretation of the Umbrella Clause in Investment Agreements,” in *International Investment Law: Understanding Concepts and Tracking Innovations: A Companion Volume to International Investment Perspectives* (Paris, OECD Publishing, 2008). Available at <http://dx.doi.org/10.1787/9789264042032-3-en>.

relation to meeting Investment Protection Agreement obligations should consider the possible effect of these obligations. As always, addressing potential abuses of the system must be balanced with not creating too much complexity for the country, given the scope of the benefits it perceives and without increasing uncertainty or investment risks for compliant taxpayers. When stability clauses became an issue for Ghana, a seven-person team was set up to review such clauses, renegotiate them where necessary and develop procedures for granting stability clauses in future.<sup>186</sup>

- (vii) One particular aspect of this is that any tax payable in the country of the mine or other facility may not be viewed as properly creditable in a treaty partner; they may view the gain as sourced offshore. Any indirect transfer legislation could specifically indicate that the gain is to be treated as domestically sourced to prevent issues in the courts. However, other countries may not accept that, leading to possible double taxation that will have some impact on the investment climate.
- (viii) In a report to the G20 proposing, in effect, a framework for further G20-related work on indirect transfers, some of these options, described as “alternative approaches to collection,” are briefly noted as follows:<sup>187</sup>
  1. Imposing a withholding obligation on the buyer/transferee;
  2. Treating a resident party as the agent for the non-resident transferor;
  3. Deeming a resident to have made the transfer; or

---

<sup>186</sup>Ghana Ministry of Finance, Duffuor Inaugurates Team to Review Mining Stability Agreements (February 2012). Available at <http://ghananewsagency.org/economics/duffuor-inaugurates-team-to-review-mining-stability-agreements-38698>.

<sup>187</sup>G20 Development Working Group, *A Report on the Issues Arising from the Indirect Transfer of Assets to Identify Policy Options to Tackle Abusive Cases, with Particular Reference to Developing Countries: Concept Note* (2015). Available at <http://g20.org.tr/wp-content/uploads/2015/11/Concept-Note-on-the-Report-on-Issues-Arising-from-the-Indirect-Transfer-of-Assets.pdf>.

4. Introducing regulatory requirements that make approval for transfer conditional on payment of the tax.

Obviously, the pros and cons of any such actions, both for administrations and for taxpayers, including the impacts on the investment climate, need to be carefully considered in deciding whether to pursue such approaches, and if so, how.

### For more information

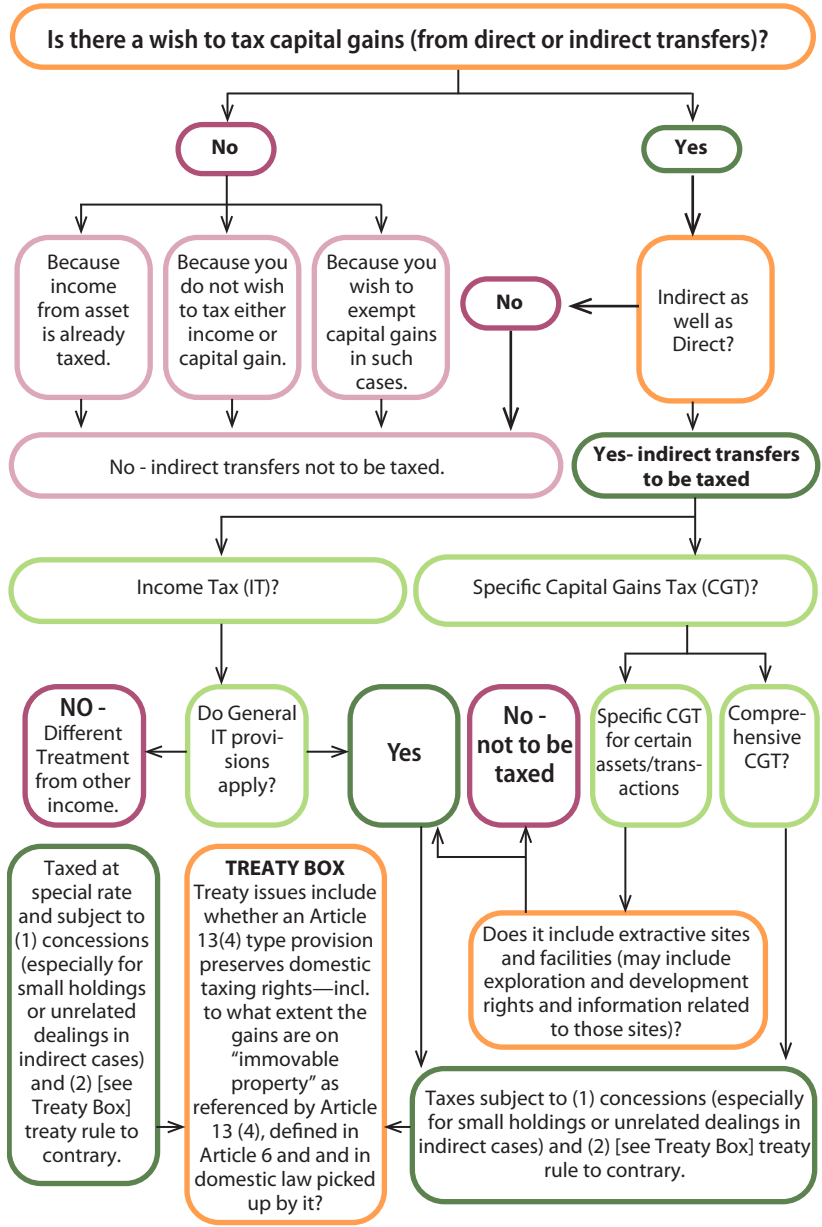
- Charles Bajungu, *Capital gains and taxation in indirect sales: experience, challenges and remedial efforts in Tanzanian perspective* (paper presented at the meeting of the Tanzania Revenue Authority and the United Nations Tax Committee, New York, October 2014). Available at [http://www.un.org/esa/ffd/wp-content/uploads/2014/11/10STM\\_PresentationBajungu.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/11/10STM_PresentationBajungu.pdf).
- Baker & McKenzie, *Breaking News: China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698* (February 2015). Available at <http://www.lexology.com/library/detail.aspx?g=b8226983-cb9e-4575-8ce8-cb9283a41706>.
- Cadwalader, Wickersham and Taft LLP, *Circular 698: The China's Anti-tax Avoidance Measures for Offshore SPVs* (August 2010). Available at <http://www.lexology.com/library/detail.aspx?g=80bb2c3b-c408-4d9a-8880-86f49c8d6fdd>.
- Jack Calder, *Administering Fiscal Regimes for Extractive Industries: a Handbook* (Washington, D.C., International Monetary Fund, 2014).
- Center for Public Integrity, *Taxing "Capital Gains" in Mozambique's Extractive Sector* (May 2014). Available at [http://www.cip.org.mz/cipdoc/307\\_Spinformacao\\_2014\\_04\\_en.pdf](http://www.cip.org.mz/cipdoc/307_Spinformacao_2014_04_en.pdf).
- IMF, OECD, UN, World Bank Group, *A Toolkit for Addressing the Taxation of Offshore Indirect Transfers* (2017).
- Jason Clements, Charles Lammam and Matthew Lo, "The Economic Costs of Capital Gains Taxes in Canada," in *Capital gains tax reform in Canada: lessons from abroad*, (Vancouver, Fraser Institute, 2014) p. 17. Available at <https://www.fraserinstitute.org/sites/default/files/economic-costs-of-capital-gains-taxes-in-canada-chpt.pdf>.
- J.J.P. De Goede, "Allocation of Taxing Rights on Income from Cross-border (indirect) Sale of Shares," in *Asia-Pacific Tax Bulletin* (May/June 2012), p. 211.

- Ernst and Young, “China released Administrative Measures for General Anti-avoidance Rules (GAAR)” in *China Tax & Investment News* (December 2014). Available at [http://www.ey.com/Publication/vwLUAssets/EY-CTIN-2014002-ENG/\\$FILE/EY-CTIN-2014002-ENG.pdf](http://www.ey.com/Publication/vwLUAssets/EY-CTIN-2014002-ENG/$FILE/EY-CTIN-2014002-ENG.pdf).
- Thomas L. Hungerford, “The Economic Effects of Capital Gains Taxation”, in *Congressional Research Service* (June 2010). Available at <https://fas.org/sgp/crs/misc/R40411.pdf>.
- IMF Fiscal Affairs Department, *Fiscal Regimes for Extractive Industries: Design and Implementation* (August 2012). Available at <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>
- Daniel K. Kalinaki, “Court gives URA nod to seek taxes on sale of Zain assets in Uganda” in *The East African* (September 2014). Available at <http://www.theeastafrican.co.ke/news/URA-taxes-on-sale-of-Zain-assets-in-Uganda/-/2558/2451578/-/item/0/-/6hm2he/-/index.html>.
- Kennedy Munyandi and others, “Tax Policy Trends in Africa— Commentary on the Major Tax Developments in 2013 and 2014”, in *Bulletin for International Taxation* (March 2015) p.154.
- OECD, *Model Tax Convention on Income and on Capital* (15 July 2014). Available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014\\_mtc\\_cond-2014-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2014_mtc_cond-2014-en#page1).
- OECD G20, *Base Erosion and Profit Shifting Project: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances: Action 6: 2014 Deliverable* (Paris, OECD Publishing, September 2014), p. 78–79. Available at <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-9789264219120-en.htm>.
- Robin Oliver, *Capital Gains Tax—The New Zealand Case* (paper presented at the Fraser Institute 2000 Symposium on Capital Gains Taxation, Vancouver, 15–17 September 2000), p. 5. Available at <https://taxpolicy.ird.govt.nz/sites/default/files/news/2000-09-12-speech-oliver-capital-gains.doc>.
- J. Phan, “Preferential Treatment of Capital Gains”, in *Contemporary Tax Journal* (Spring/ Summer 2013).
- Karl Schmalz, “Capital Gains Issues in the Extractive Industries”, in *Tax Notes International*, vol. 84 (October 2016), p. 91. Available at [http://iticnet.org/images/84TI0091\\_Schmlz.pdf](http://iticnet.org/images/84TI0091_Schmlz.pdf).
- S. Simontacchi, “Immovable Property Companies as Defined in Paragraph 13(4) of the OECD Model,” in *Bulletin of International Taxation* (2006) vol. 60, No. 1, p. 29.

- UNCTAD, “Fair and Equitable Treatment”, in *UNCTAD Series on Issues in International Investment Agreements II* (New York, United Nations, 2012). Available at [http://unctad.org/en/Docs/unctaddiaeia2011d5\\_en.pdf](http://unctad.org/en/Docs/unctaddiaeia2011d5_en.pdf).
- Edwin T. Whatley and Shinichi Kobayashi, “Taxation of Indirect Equity Transfers: Japan”, in *17 Asia-Pacific Tax Bulletin* 2 (2011), p. 138.
- United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2011). Available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).
- United Nations, Department of Economic and Social Affairs (2018). *2017 United Nations Model Taxation Convention between Developed and Developing Countries*. Available at <http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html>
- Victoria University of Wellington Tax Working Group, *A Tax System for New Zealand's Future* (2010). Available at <http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf>.
- Debra J. Villarreal and Lucas LaVoy, Texas Oil and Gas Exploration and Development Agreements, in *31 Energy & Min. L. Inst.* 10 (2010). Available at [https://www.emlf.org/clientuploads/directory/whitepaper/Villarreal\\_LaVoy\\_11.pdf](https://www.emlf.org/clientuploads/directory/whitepaper/Villarreal_LaVoy_11.pdf).
- Katia Yannaca-Small. “Interpretation of the Umbrella Clause in Investment Agreements”, in *International Investment Law: Understanding Concepts and Tracking Innovations: A Companion Volume to International Investment Perspectives* (Paris, OECD Publishing, 2008). Available at <http://dx.doi.org/10.1787/9789264042032-3-en>.
- Qiguang Zhou, “The Relationship between China’s Tax Treaties and Indirect Transfer Anti-avoidance Rules”, in *Tax Notes International*, vol. 74, No. 6 (May 12), p. 43.

Annex I

Figure IV.A1:  
Taxation of Indirect Offshore Transfers



## Annex II

### SYMMETRY IN CAPITAL GAINS TAXATION

Capital gains taxation rules are as important to the buyer as they are to the “taxpaying” seller. When a seller is taxable on its gain, measured by its sales price over its remaining cost basis in an asset, the buyer takes as its beginning tax basis the same price (in this case, its purchase price) for measuring future income or capital gains. Unless this occurs, the structure of the tax law itself will impose double taxation, contrary to basic taxation principles. While this “symmetry” is clearly understood as an important principle for in-country direct sales of operating assets, its impact is equally important in the case of indirect sales that may take place outside of the country.

To fully appreciate the importance of symmetry in this context it is critical to understand the economic analysis underlying sales transactions and, in particular for purposes of this chapter, sales transactions involving extractive assets and operations. Consider the following fact pattern. Opco owns and operates an oil well in Country X. Opco is a resident of Country X and is owned by Holdco, which is a resident of country Y.

Opco’s well is expected to generate net cash (cash revenues less cash operating/capital expenses) of 100 for each of the next 10 years. For tax purposes, Opco’s well is fully depreciated and there are no other differences between net cash and taxable income during the 10-year period. Assuming a Country X tax rate of 50 per cent, Opco expects to generate after-tax net cash of 500 over 10 years ( $100 \times 10 = 1,000 - 50 \text{ per cent tax rate} = 500$ ). Country X will receive 500 in tax revenues over the same 10-year period.

Assume Buyer has expressed an interest in buying Opco’s well. To reach an agreement, Buyer and Opco will have to arrive at a mutually agreeable sales price. Putting aside for the moment financial principles that deal with the present value of money,<sup>188</sup> Opco would

---

<sup>188</sup> These principles are very important and are essential to understanding the impact of tax depreciation rules on the incentives for investors to risk and invest capital.

demand an after-tax sales price of at least 500, which is the expected after-tax cash from retaining the well. Likewise, Buyer will only be willing to pay a sales price that is, at most, equal to the after-tax cash that it expects to receive from the well. Thus, the tax treatment of the transaction will have a significant impact on whether Opco and Buyer will be able to reach a mutually agreed upon price. In general, if the tax rules of Country X allow for symmetrical treatment, then there would be no tax impediment to Opco and Buyer reaching a deal.

**Symmetry: seller’s gain taxed / buyer deducts purchase price**

Under these rules, assume for simplicity’s sake that Buyer is willing to pay 1,000 to Opco for the well. Buyer’s economic analysis of this decision would be as follows. Assuming the well generates the same net cash of 100 over 10 years, Buyer’s future depreciation deductions (that were not available to Seller) will offset taxable income generated from the well and as a result Buyer’s future net after-tax cash generated is 1,000. Under these simplified facts, Buyer “breaks even” on this investment.

|                | <b>Cash</b> | <b>Tax Calculation</b> |
|----------------|-------------|------------------------|
| Income         | 1 000       | 1 000                  |
| Tax Deduction  |             | <u>(1 000)</u>         |
| Taxable Income |             | 0                      |
| Tax            | 0           | 0                      |
| After-tax Cash | 1 000       |                        |

Seller, on the other hand, will accept the 1,000 knowing that it is fully taxable at 50 per cent because the after-tax cash to seller will be the same 500 that Seller expected to receive from continuing to own and operate the well. Country X receives the same 500 in revenue that it would have received absent a sale.

**Symmetry: Seller’s gain not taxed/no deduction for Buyer (typical offshore indirect sale)**

In this case, for Buyer to have a “break-even” investment, it would be willing to pay only 500 for the well because that is the expected after-tax cash generated from operation of the well. Under these rules,



Buyer basically steps into the shoes of Opco and has the same after-tax result that Opco would have had: 1,000 of before-tax cash minus 500 of tax paid nets 500 of after-tax cash. Seller is willing to accept the 500 because it is not subject to tax and therefore Seller's after-tax cash from the sale is also 500. Country X will receive 500 in revenues and is in the same position as before.

These two fact patterns are instructive, because they demonstrate, contrary to assertions frequently made, that a Seller can avoid local country tax through an offshore sale and that such a sale deprives developing countries of tax revenues.<sup>189</sup> Notice that in this case Opco bears the full brunt of the Country X tax. Buyer's calculation of the sales price it is willing to pay to Opco is based on the *after-tax* cash flow that is expected from the well. In other words, even though the well generates 1,000 of revenues, Buyer is only willing to pay Opco 500 after deducting the expected tax payments of 500. Country X also is kept whole and will still receive 500 of revenue.

### **Nonsymmetrical treatment: Seller's gain taxed/no deduction for Buyer**

Under these rules, Buyer will only be able to break-even by paying Opco 500 for the well because, as explained above, that is the expected after-tax cash flow from the well. For Opco, a payment of 500 is insufficient because the sale would be subject to 250 of tax by Country X ( $500 \times 50$  per cent); therefore, Opco's after-tax cash is only 250 ( $500 - 250$ ) which results in an effective tax rate of 75 per cent—i.e., double taxation.

Some may argue that this tax regime is favourable for Country X because it will receive 750 of tax revenues (250 from Opco as a result of the sales transaction plus 500 from Buyer as a result of the ongoing operations of the well). However, it is unlikely that this windfall to Country X will ever materialize. As stated previously, the sales transaction will only take place if Opco and Buyer can arrive at an agreeable price. Under this

---

<sup>189</sup> OECD, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS In Low Income Countries*, (July 2014). Available at <http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf>

tax regime, the likelihood of that happening is extremely unlikely. As a result, the sales transaction will not take place and Opco will remain operator of the well. In the long run, this may be detrimental to Country X if Buyer would have been a more efficient operator or would have been more willing to make additional investments.

### **Nonsymmetrical treatment: Seller's gain not taxed/Buyer deducts purchase price**

Under these rules, Country X would subsidize the sales transaction between Opco and Buyer. For the reasons explained above, Buyer would be willing to pay 1,000 for the well. Seller would receive a windfall in this case because the after-tax cash to Seller would also be 1,000 if the sale is not subject to tax. Country X would receive zero tax revenues under this regime.

In conclusion, a tax regime that provides symmetrical treatment for the Seller and the Buyer will protect the country's revenue and will not present an economic impediment to investors seeking to maximize efficiencies.

Even if a system is designed to create symmetry, there is still a question as to which approach is the best, i.e., tax gains to the Seller but allow a deduction for the Buyer or do not tax gains to the Seller but likewise do not allow deductions based on the purchase price to the Buyer. This ultimately becomes a question of timing. For example, under the Opco example above, if the gains are taxed, then Country X receives a lump sum of 500 in the first year and then nothing in future years. If the gains are not taxed, Country X continues to receive a steady stream of 50 in revenues for the next 10 years. Which is best for Country X? Obviously, many factors come into play but one item that public finance experts may consider is whether Country X's budgeting and spending processes are sufficiently disciplined to account for one-time acceleration of expected revenues. Would one year's spike in revenues be mistaken for a continuing trend or would other pressures force the revenues to be spent, effectively mortgaging the future? Alternatively, would it be better from a budgeting perspective to be able to rely upon a stable income flow in future years? A country will need to weigh these factors in making a policy decision on this significant issue.

## Chapter 5

### TRANSFER PRICING ISSUES

#### Executive summary

The first edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) was issued in 2013 in response to the need expressed by developing countries for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) commonly occurring in developing countries. The Manual was updated and revised in 2017.<sup>190</sup>

The Manual is based on the work of the Subcommittee on Article 9 (Associated Enterprises) pursuant to a mandate with the following requirements:

- (i) That it reflects the operation of Article 9 of the United Nations Model Convention, and the arm's length principle embodied in it, and is consistent with relevant Commentaries of the United Nations Model Convention;
- (ii) That it reflects the realities for developing countries, at their relevant stages of capacity development;
- (iii) That special attention should be paid to the experience of developing countries; and
- (iv) That it draws upon the work being done in other forums.

The 2017 Manual is organized into four parts:

- (i) Part A relates to transfer pricing in a global environment;
- (ii) Part B contains guidance on design principles and policy considerations;
- (iii) Part C addresses practical implementation of a transfer pricing regime in developing countries; and
- (iv) Part D contains country practices.

---

<sup>190</sup> The updated United Nations on *Transfer Pricing for Developing Countries* is available at <http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf>.

The Manual does not address industry-specific issues, but serves to provide general guidance on technical aspects such as (i) the need for and how to conduct a comparability analysis; (ii) the respective available transfer pricing methods and how they operate; (iii) transfer pricing issues particular to intra-group services; (iv) transfer pricing considerations for intangible property; (v) cost contribution arrangements; (vi) transfer pricing of business restructurings; and (vii) the general legal environment relating to domestic transfer pricing legislation. The Manual also provides guidance on administrative issues such as transfer pricing documentation, audits and risk assessment, dispute avoidance and resolution and establishing transfer pricing capability in developing countries. Finally, the Manual provides an overview of certain country practices and perspectives on transfer pricing.

In the course of the work of the Extractive Industries Subcommittee, a need was identified to develop a guidance document containing and analysing some examples on transfer pricing issues in extractive industries, both relating to the production of oil and natural gas and relating to mining and minerals extraction.

This chapter responds to that need and highlights some of the transfer pricing issues arising in the extractive industries. The chapter draws on materials that have been published in other forums, including the Platform for Cooperation on Tax (the Platform) reflecting enhanced collaboration between the International Monetary Fund (IMF) Organization for Economic Cooperation and Development (OECD), the United Nations and the World Bank Group (WBG) for the benefit of developing countries. Reference can be made to the Platform's Toolkit for *Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses*.<sup>191</sup> The Toolkit includes a Supplementary Report on *Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form* (the Supplementary Report). Reference can also be made to the WBG Extractive Industries work and materials<sup>192</sup> and the publication *Transfer Pricing in Mining with a Focus on Africa*.<sup>193</sup>

---

<sup>191</sup> Available at <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>.

<sup>192</sup> Available at <http://www.worldbank.org/en/topic/extractiveindustries/overview>.

<sup>193</sup> Pietro Guj et al., *Transfer pricing in mining with a focus on Africa*:

This chapter looks specifically at the value chain of mining and mineral extraction and of the production of oil and natural gas. Table VI.1 in the first part of the chapter identifies some of the transfer pricing issues that often arise in the extractive industries. The table is organized by reference to the various major stages in the extractive industry value chain. The table makes some general suggestions on methods and approaches that might be used in addressing the identified issues.

Thereafter, the chapter provides several case examples, some of which result from discussions with tax inspectors working in developing countries. Taken together, the table and the examples provide useful background information for developing countries to utilize in addressing transfer pricing issues in extractive industries. The chapter does not aspire to provide comprehensive transfer pricing guidance for the extraction industries, but should provide a useful summary and checklist of some of the issues that commonly arise. It is recommended that this extractive industry chapter and the Manual be consulted together.

### **Transfer pricing issues that may arise in the extractive industries**

Transfer pricing issues in the extractive industries that in particular may affect developing countries include:

- (i) Fragmentation of the supply chain and ability to locate functions in order to allocate profits to:
  - i. Marketing / procurement companies or branches; and
  - ii. Offshore hedging companies.
- (ii) Fragmentation of transactions (i.e., where MNEs enter into convoluted structures involving the inter-positioning of multiple companies, generally in low-tax jurisdictions (splitting out of functions and risks) to divide profits);
- (iii) Thin capitalization;

---

*a reference guide for practitioners* (Washington, D.C., World Bank Group, Centre for Exploration Targeting, Minerals and Energy for Development Alliance, 2017). Available at <http://documents.worldbank.org/curated/en/801771485941579048/pdf/112346-REVISED-Dated-Transfer-pricing-in-mining-with-a-focus-on-Africa-a-reference-guide-for-practitioners-Web.pdf>.

- (iv) Intra-group charges (e.g., technical fees and management fees); and
- (v) Taxpayers using offshore marketing companies to divide profits, arguing that they are securing demand through customer relationships, smart contracting and high-quality services—all of which are key to placing product in the market and to overall value creation.

Table VI.1 below presents the transfer pricing issues that might develop during the course of business for those engaged in the extractive industry. These issues arise in conjunction with the major stages in the life of an extractive industry activity.

### **Generic case examples**

The following case examples are generic in nature for the extractive industry, meaning that the same facts and circumstances may arise in the extraction of ore and in the oil and gas industry.

#### ***Example 1: Marketing hub***

##### *Facts*

Parent company A established marketing entity B in a low-tax jurisdiction. Company B is described by the taxpayer as a fully-fledged marketing/distribution company responsible for servicing demand for a specific commodity and growing the business for the entire MNE group.

The operations are staffed by a very limited number of management and administrative employees. Company B maintains that its operations perform a strategic and vital role, are fully risk taking (entrepreneurial risk) by buying and selling the refined product and performs value added functions that warrant a high return.

##### *Findings*

After examining the activities and functions performed by Company B, a tax audit reveals that Company B actually provides management and marketing support services rather than being a full risk marketing/distribution company as purported. The functions actually performed only warrant a routine return.

Table V.1:  
Transfer pricing issues in that may arise in the extractive industries

| Stage                                                                            | Industry              | Why is it an issue?                                                                                                                                                                                                       | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                      |
|----------------------------------------------------------------------------------|-----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>A: Negotiation and bidding</b>                                                |                       |                                                                                                                                                                                                                           |                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 1. Acquisition of data from related parties                                      | Mining<br>Oil and Gas | Where the geological data is acquired from a related party, there is risk of overstatement of the acquisition cost (for deduction or depreciation).                                                                       | Use traditional transfer pricing (TP) methods (Comparable Uncontrolled Price — CUP — or Cost Plus) to assure reasonability of the price. However, comparability may be a real issue.<br>Transfer of (geological) data might occur directly or indirectly by transferring the shares in the entity holding the data.                                                                                                                         |
| 2. Acquisition of extraction rights from related parties                         | Mining<br>Oil and Gas | A difficulty at this stage may be the valuation of the likelihood of success.<br>Transfer pricing may be used as a technique to shift profit between parties in this early phase of the process.                          | Use of a valuation technique may be most appropriate.<br>Comparability may be a real issue.<br>Not applicable in countries where extractive rights are not granted to foreigners. In that case, there is probably no cross-border transfer pricing issue.<br>Transfers of extraction rights might happen directly or indirectly by transferring the shares in the entity holding the rights.                                                |
| 3. Advisory, consultancy, managerial and technical services from related parties | Mining<br>Oil and Gas | The costs for services form part of the capital expenditure that can be deducted against extraction income, and a carry forward can be allowed if there is insufficient current income to offset the capital expenditure. | First consider the benefit test to ensure that the services are chargeable (general reference is made to part B.4 (“Intra-group services”) in the United Nations Practical Manual on Transfer Pricing for Developing Countries (“the Manual”). Consider the most appropriate TP method (CUP, Cost Plus or Transactional Net Margin Method — TNMM — based on cost). Focus on verifying how the components of the cost base were established. |

Table V.1: (cont'd)

| Stage | Industry | Why is it an issue?                                                                                                                                                                                                       | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
|-------|----------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|       |          | <p>In case the expenses from this stage may be deductible in the future, the company may be motivated to overstate the price for such services to allow for future deductibility in the form of carry-forward losses.</p> | <p>Additional mitigation of such practices may take place when withholding taxes apply under domestic laws and also where taxing rights are retained under the Double Tax Treaty (i.e., through the Technical Services article).</p> <p>Some countries may have reporting obligations for outbound payments of service fees, which can help identify expenses and which may help counter the overstatement of expenses.</p> <p>Charging and allocation of costs are discussed in the Manual, paragraphs B.4.3.5 to B.4.3.9, and allocation keys are discussed from B.4.56 to B.4.62.</p> <p>In the oil and gas industry, it has been a common and longstanding practice that services to projects, especially in the upstream life cycles, are provided at fees that ensure recovery of costs, without the inclusion of a profit margin or markup for the service provider. There is a tension between the joint venture partners on the one hand, who do not allow a profit markup where on the other hand the jurisdiction of the service providers would like to see a markup. Different authorities have different views as to whether this is at arm's length. Potentially, this can be seen as a cost contribution arrangement. For more details see part B6 of the Manual or alternatively this issue could be addressed through a bilateral advance pricing agreement (APA).</p> |



Table V.1: (cont'd)

| Stage                     | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                             | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|---------------------------|-----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4. Performance guarantees | Mining<br>Oil and Gas | <p>It is not uncommon for the host country that awards a licence to a company to seek some form of guarantee from or through the parent company regarding the performance of the exploration and development contract.</p> <p>The transfer pricing question here is whether contract-related guarantees require an arm's length charge. Financing guarantees clearly would.</p> | <p>For example, the India Model Production Sharing Contract provides for a full parent company guarantee, as well as a bank performance bond (for 7.5 per cent of the contract obligations at various stages). Article 29.1 of the Contract states that "[e]ach of the Companies constituting the Contractor shall procure and deliver to the Government within thirty (30) days from the Effective Date of this Contract: (a) an irrevocable, unconditional bank guarantee from a reputed bank of good standing in India, acceptable to the Government, in favour of the Government, for the amount specified in Article 29.3 and valid for four (4) years, in a form provided at Appendix-G; (b) financial and performance guarantee in favour of the Government from a Parent Company acceptable to the Government, in the form and substance set out in Appendix-E1, or, where there is no such Parent Company, the financial and performance guarantee from the Company itself in the form and substance set out in Appendix-E2; (c) a legal opinion from its legal advisers, in a form satisfactory to the Government, to the effect that the aforesaid guarantees have been duly signed and delivered on behalf of the guarantors with due authority and is legally valid and enforceable and binding upon them[.]" (Available at <a href="http://petroleum.nic.in/sites/default/files/MPSC%20NELP-V.pdf">http://petroleum.nic.in/sites/default/files/MPSC%20NELP-V.pdf</a>)</p> <p>Nigeria has similar provisions requiring both parent company guarantees and a bank performance bond. See Production Sharing Contract between Nigerian National Petroleum Corporation and Gas Transmission and Power Limited, Energy 905 Suntera</p> |

Table V.1: (cont'd)

| Stage                                | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                               | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|--------------------------------------|-----------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>B: Exploration and appraisal</b>  |                       |                                                                                                                                                                                                                                                                                                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| 1. Transfer of exploration equipment | Mining<br>Oil and Gas | <p>Transfer of new equipment from a related party may not be at arm's length, especially with long-lead equipment in a volatile world.</p> <p>Transfer of existing equipment at a price that is too high may result in a step up in base. Extra attention may be required when the sale is structured through an intermediary related entity with a favourable tax treatment.</p> | <p>Look at the proper application of the transfer pricing methods. Consider the application of group synergies (paragraphs B.5.2.28 of the Manual) and consider closer cooperation between customs and review of customs valuation (para. B.2.4.7).</p> <p>This risk may be amplified if the jurisdiction has customs exemption for exploration equipment.</p> <p>The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.</p> <p>For oil and gas, the cost-only practices described in section A.3 of this table and the required agreement of joint venture partners may reduce these risks for the country whose resources are being developed.</p> |
| 2. Lease of exploration equipment    | Mining<br>Oil and Gas | <p>Overstatement of lease rental rates is possible, either because of hiring from related parties or arrangements made by related parties.</p>                                                                                                                                                                                                                                    | <p>Look at the proper application of the transfer pricing methods. Consider the application of group synergies (paragraphs B.5.2.28. of the Manual) and risk assessment (paragraphs B.2.3.2.23.).</p> <p>The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.</p>                                                                                                                                                                                                                                                                                                                                                                                  |

Table V.1: (cont'd)

| Stage                                                                                         | Industry              | Why is it an issue?                                                                                                                                                                                                | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
|-----------------------------------------------------------------------------------------------|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3. Exploration services: seismic, drilling, sampling and analyses                             | Mining<br>Oil and Gas | Related parties' involvement in these activities may lead to overstatement of the value of these services, which creates high cost base for future depreciation.                                                   | Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table.<br><br>See section A.2 of this table. Applicable tax treaties may have specific rules for the extractive industry, e.g., exploration-related permanent establishments. Reference is made to the discussion in Chapter 3 on Permanent Establishments.<br><br>Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table. |
| 4. Administrative, managerial and technical services, and legal services from related parties | Mining<br>Oil and Gas | Where the expenses from this stage may be deductible in the future, the company may be motivated to overstate the price for such services to allow for future deductibility in the form of carry-forward losses.   | See section A.3 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| 5. Financing/Guarantee/Funding arrangements                                                   | Mining<br>Oil and Gas | Level of possible interest payments which may be deferred (initially interest free loan then later interest bearing)<br><br>Unrelated parties may not be able to obtain a loan at this risky stage of the project. | This may (or may) not be a transfer pricing issue and may be addressed under domestic law.<br><br>The transfer pricing issue would typically be the applicable interest rate or guarantee fee.                                                                                                                                                                                                                                                                                                                          |

| Table V.1: (cont'd)                                                              |                       | Industry                                                                                                                                                                                                                                                          | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                                                                                                                            | How to deal with this? |
|----------------------------------------------------------------------------------|-----------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------|
| <b>C: Development</b>                                                            |                       |                                                                                                                                                                                                                                                                   |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |                        |
| 1. Sale/lease of extraction rights — (royalty payment/ sales value)              | Mining<br>Oil and Gas | Assignment of extractive rights to related company or outright transfer of extractive rights to related company can be at a high cost and it may be the case that the proceeds from the transfer of the extractive right may not be taxable in some jurisdictions | See section A.2 of this table. Please note that, at this stage, the value of the rights may have changed as you have more information on the success of the project. For example, there may be more certainty around the development plan and the extent of proven or probable reserves.<br><br>Please note that farm-in/farm-out considerations may be relevant at this stage of the process. Reference is made to the discussion in Chapter 4 (Indirect Transfer of Assets). |                        |
| 2. Purchase/ lease of plant, equipment and machinery                             | Mining<br>Oil and Gas | See sections B.1 and B.2 of this table.                                                                                                                                                                                                                           | See sections B.1 and B.2 of this table. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1.                                                                                                                                                                                                                                                                                                                        |                        |
| 3. Advisory, consultancy, managerial and technical services from related parties | Mining<br>Oil and Gas | See section B.3 of this table.                                                                                                                                                                                                                                    | See section B.3 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                                 |                        |
| 4. Financing/guarantee/ funding arrangements                                     | Mining<br>Oil and Gas | The interest rate or other conditions of the financing agreement could give rise to transfer pricing issues.                                                                                                                                                      | See section B.4 of this table. Some countries may address this issue in their non-transfer pricing rules. In this respect see, for example, Action 4 final report of the OECD BEPS Project.                                                                                                                                                                                                                                                                                    |                        |

Table V.1: (cont'd)

| Stage                                                                            | Industry              | Why is it an issue?                                                                                                                                                          | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|----------------------------------------------------------------------------------|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>D: Production/extraction stage</b>                                            |                       |                                                                                                                                                                              |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| 1. Lease of concession rights (royalty payment)                                  | Mining                | Concession owner leases the right to exploit to a related company in exchange for remuneration.                                                                              | There may be a difference between the tax treatment of a sale or a lease. This in itself is not a transfer pricing issue, but relates to whether the transaction is a bona fide sale or bona fide lease. In this respect, reference is made to the Manual, paragraphs B.2.3.1.4 – B.2.3.1.9.                                                                                                                                                                                                                                                                          |
| 2. Payments for purchase or lease of extractive equipment                        | Mining<br>Oil and Gas | See sections B.1 and B.2 of this table.                                                                                                                                      | The transfer pricing issue regards whether the sale price or the lease payments qualify as arm's length (comparability analysis process).<br>See sections B.1 and B.2 of this table. Reference is also made to the comment on the cost-only practices and the joint venture partners above in B.1.                                                                                                                                                                                                                                                                    |
| 3. Advisory, consultancy, managerial and technical services from related parties | Mining<br>Oil and Gas | See section A.3 of this table.<br>At this stage of the process, the MINE may be earning sales income and subsequently service fees may be charged calculated based on sales. | See section A.3 of this table.<br>A service fee calculated as a percentage of sales may not be appropriate as it may overcompensate the costs. Typically, payment for services would be calculated by reference to the cost of the actual services provided. This may require an allocation of group costs among operating entities based on allocation keys.<br>For purpose of the allocation of a pool of costs, an appropriate allocations key should be used. Reference is made to paragraphs B.4.4.19 of the Manual for examples of appropriate allocation keys. |

Table V.I: (cont'd)

| <b>Stage</b>                                                                                                                                      | <b>Industry</b>       | <b>Why is it an issue?</b>                                                                                                                                                                                    | <b>How to deal with this?</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|---------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4. Payments for use of intellectual property (IP)                                                                                                 | Mining<br>Oil and Gas | At the production stage, the use of technology provided by related parties is important. Calculating the appropriate transfer price may be a challenge.                                                       | Reference is made to part B.5 of the Manual as it contains a comprehensive elaboration on this issue. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table.                                                                                                                                                                                                                                                                                                                                                       |
| 5. Mining subcontracting services and special regimes (where tax rates for mining services and production operations are significantly different) | Mining                | In cases where there is a lower tax rate for mining services and mining operation compared to the local corporate tax rate, profit shifting through transfer pricing/mispricing may offer even more benefits. | This may be a case of shifting profits between different tax regimes within country. Use traditional TP methods (CUP or Cost Plus) to assure reasonability of the transfer price of the services provided. However, comparability may be a real issue.                                                                                                                                                                                                                                                                                                                                    |
| 6. Contract mining services                                                                                                                       | Mining                | In cases where mining services are outsourced to a related offshore entity that purportedly is carrying far more risk, income may be shifted offshore.                                                        | In this case, a proper functional analysis is required to properly delineate transaction and risk allocation. See the Manual, paragraph B.2.3.1.4 on delineation of the transaction. Developing countries should be aware of the fact that the OECD BEPS Action 8 – 10 also affect mining and extraction industries and that transfer pricing can be used to shift income and tax base offshore to low-tax jurisdictions. In these scenarios, it is recommended that the step-analysis listed in the Manual at B.2.3.1.4 and the risk analysis in the Manual at B.2.3.2.23 be considered. |

| Table V.1: (cont'd)                     |                       |                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|-----------------------------------------|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Stage                                   | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                                  | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 7. Sale of raw minerals and adjustments | Mining                | An ore can contain various minerals at this unrefined phase, making it difficult to determine the price.                                                                                                                                                                                                                                                                             | <p>Considering the actual characteristics of the mineral is important in helping determine the arm's-length price in the sale between related parties.</p> <p>Reference is made to the Platform's Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses.<sup>4</sup> Especially its Supplementary Report, Addressing the Information Gaps on prices of Minerals Sold in an Intermediate Form (the "Supplementary Report").</p> |
| 8. Interest income/interest expenses    | Mining<br>Oil and Gas | <p>Both the interest income and interest expense need to be priced at arm's length.</p> <p>The fact that a company is highly capitalized and at this stage of the extraction process may be cash rich, it may prefer to issue a loan to a related party over making a dividend distribution. It's debated in some jurisdictions whether this is a transfer pricing issue or not.</p> | <p>See section B.4 of this table.</p> <p>Reference can be made to the OECD discussions on cash pooling.</p>                                                                                                                                                                                                                                                                                                                                                             |

| Table V.1: (cont'd)                                                                                                   |                       |                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
|-----------------------------------------------------------------------------------------------------------------------|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Stage                                                                                                                 | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                            | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| <b>E. Processing (refining and smelting)</b>                                                                          |                       |                                                                                                                                                                                                                                                                                                                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| 1. Tolling fee for contract processing                                                                                | Mining<br>Oil and Gas | <p>At issue is the appropriateness of the tolling fee where tolling is done by a related party to the concentrate producer. There is a risk that the fee may not be at arm's length.</p> <p>In cases where mining services are outsourced to a related offshore entity purportedly carrying far more risk, income may be shifted offshore.</p> | See section E.6 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 2. Adjustments to the reference price (treatment charges, refining charges, penalties and price participation clause) | Mining<br>Oil and Gas | <p>Payments for the concentrates are often based on reference pricing. Through treatment charges, refining charges and other payments can be used to shift profits where the parties involved in the process implementing these charges are related parties, if they are not priced at arm's length.</p>                                       | <p>The price of the commodity is based on a reference price adjusted by items such as treatment charges, refining charges, credits for recoverable metals, or penalties for impurities.</p> <p>Such adjustments are often calculated by reference to industry averages and a transfer pricing issue can arise if a company departs arbitrarily from the industry practice.</p> <p>Reference is made to the Platform's Supplementary Report.</p> <p>In the situation of the price participation agreement in the mining industry, if the smelter is a related party, it needs to be determined whether any price adjustments are arm's length. Therefore,</p> |



Table V.1: (cont'd)

| Stage | Industry                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | How to deal with this? |
|-------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------|
|       | <p>In the mining industry, credits for recoverable metals (e.g., precious metals in a copper or cobalt concentrate) may be under-priced. Similarly, penalties for impurities in the concentrates may be overpriced.</p> <p>In the mining industry smelters sometimes enter into a price participation agreement where the price of the commodity is adjusted based on the fluctuation of the market price of the commodity. They may receive an additional fee or get an additional charge.</p> <p>In oil and gas, the acquisition and sale of crude oil and natural gas (LNG) from upstream producers to the midstream and downstream sector may be to related or third parties.</p> | <p>industry know-how is crucial. Reference is made to the pricing practices paragraph of the Platform's Supplementary Report.</p> <p>As regards oil and gas, many different oil benchmarks exist, with each one representing crude oil from a particular part of the globe, however, most of them are referred to one of three primary benchmarks that serve as a reference price for buyers and sellers of crude oil: the West Texas Intermediate (WTI) Brent Blend, and Dubai/Oman. Depending on the type of crude oil, these benchmarks are generally adjusted depending on crude density (e.g., American Petroleum Institute (API) gravity) location or other factors different from the reference index. These benchmark prices are published by reliable international organizations as Platts, Oil Price Information Service (OPIS) Argus or the New York Mercantile Exchange (NYMEX) and widely used by the public and private sector.</p> <p>To calculate the taxable income of oil and gas companies, most producing countries have set tax reference prices (also known as norm prices) for given time periods. These reference prices are established by the government (e.g., a Petroleum Council) or the National Oil Company (NOC) in order to provide oil and gas prices that best represent the market conditions.</p> <p>These reference prices are normally determined from the assessment of the crude oil international benchmarks mentioned above</p> |                        |

| Table V.1: (cont'd)                                                              |                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|----------------------------------------------------------------------------------|-----------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Stage                                                                            | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|                                                                                  |                       | <p>Normally, these transactions are priced “at index” which means that such transactions are based upon market prices, generally referring the price of a barrel of crude oil to oil benchmarks.</p> <p>It needs to be considered whether the right benchmark is used and if the price used for the intercompany transaction may need to be adjusted depending on crude density (e.g., API gravity) location, sulphur content or other factors different from the referenced index.</p> | <p>(e.g., Platt’s market indicators) generally adjusted to the specific gravity API of the actual crude produced, resulting a valid comparable for oil and gas transactions performed in the country. In some countries, the body in charge of setting the reference prices takes also into account the market indicators presented by the companies operating in their jurisdiction (based on price quotations from official publications and their own observations).</p> |
| 3. Advisory, consultancy, managerial and technical services from related parties | Mining<br>Oil and Gas | See section A.3 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                                          | See section A.3 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| 4. Payments for use of IP                                                        | Mining<br>Oil and Gas | See section D.4 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                                          | See section D.4 of this table.                                                                                                                                                                                                                                                                                                                                                                                                                                              |

Table VI.1: (cont'd)

| Stage                                                          | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | How to deal with this?                                                                                                                                                                                                                                                                                       |
|----------------------------------------------------------------|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 5. Transportation                                              | Mining<br>Oil and Gas | <p>The calculation of prices of transportation is generally based on comparables and Incoterms are relevant in this industry. The question is whether the Incoterms are appropriately applied within related party transactions.</p> <p>In the oil and gas industry, long-term commitments are common and present risks if short-term conditions change. In the event payments are made between related parties based on changed conditions or transportation risks materializing, it should be determined whether these payments (penalties, fees) are at arm's length.</p> | <p>Comparability factors need to be checked. Double check if the risks allocated to a related party can be managed and controlled by that party.</p> <p>The original contract should be reviewed considering the facts and circumstances that were available at the time of the signing of the contract.</p> |
| 6. Transfer pricing where different tax regimes are applicable | Mining<br>Oil and Gas | <p>The risk of profit shifting may arise in case there are different tax regimes available in a country.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | <p>Reference is made to the United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries and to the issue of safe harbors, discussed in the Manual at B.8.8.</p>                                                                                                            |

Table V.1: (cont'd)

| Stage                         | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                                         | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|-------------------------------|-----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                               |                       | <p>The processing and refining activities are often subject to lower tax rates than the extractive tax regimes.</p> <p>Considering domestic law, a transfer pricing analysis may be required, also when one company shifts value between two different tax regimes. (i.e., net-back calculations).</p>                                      | <p>It should be considered whether domestic laws even allow transfer pricing rules to apply in domestic transactions or, where (in the case of the same enterprise) the activity takes place within the same legal entity but with a different tax regime, the transfer pricing rules should also apply for the intra-company transaction, between the ring-fencing regimes.</p>                                                                                                                                                                                                                                                                                                                                                                                                                               |
| <b>F: Sales and marketing</b> |                       |                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| 1. Marketing hubs             | Mining<br>Oil and Gas | <p>The issue is to determine whether a related marketing hub is remunerated at arm's length, considering there are several remuneration models available.</p> <p>A company may be paid commissions under an off-take agreement that it has with producer. The commission needs to be reviewed as to whether the fee is at arm's length.</p> | <p>This can vary and therefore arrangements must be properly investigated. It is important to consider the delineation of the transaction and, from that, the basis for payments for sales/marketing and their relationship to value creation in the industry. For instance, it is commonly argued that a marketing hub is analogous to a “distributor” of goods and hence should be rewarded by way of a percentage of sales. Consider whether the FAR of the marketing entity are in fact analogous to a typical distributor. Consider also the value-add of the marketing entity to the commodity product and the potential impact that may have on the arm's-length remuneration for the transaction.</p> <p>Reference is also made to the Manual, para. B.2.3.1.4. on delineation of the transaction.</p> |

Table V.1: (cont'd)

| Stage                                                        | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                  | How to deal with this?                                                                                                                                                                                                                                                                                                                                                                           |
|--------------------------------------------------------------|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2. Hedging gains and losses                                  | Mining<br>Oil and Gas | There is an issue when related party is the buyer of the commodity and is also the one doing the hedging for the producer.                                                                                                                                                                           | It needs to be determined whether the hedging gains and losses are allocated at arm's length. Issues to consider are whether hindsight is being used or if the hedge is asymmetric. Some countries under domestic laws have a regime in place that separates hedging gains and losses from extractive activities.                                                                                |
| 3. Payment terms such as credit interest on advance payments | Mining<br>Oil and Gas | Determination of arm's-length prices should take into account the relevant payment terms.                                                                                                                                                                                                            | Payments made before or after the time when an unrelated party would have made payment may need to be adjusted for the time value of money.<br>Consideration could be given to whether the payment terms have an inappropriate impact on the fiscal take (e.g., royalties).                                                                                                                      |
| 4. Transportation                                            | Mining<br>Oil and Gas | See section E.5 of this table.                                                                                                                                                                                                                                                                       | See section E.5 of this table.                                                                                                                                                                                                                                                                                                                                                                   |
| 5. Sales price of commodities                                | Mining<br>Oil and Gas | The key risk is undervaluation of the commodity value in sales to related parties. By undervaluing the price of the commodity, not only the income tax revenue but also revenue in the form of royalties and other mineral taxes (additional profit tax, mining taxes) can be significantly reduced. | Use of traditional TP Methods — CUP Method. Also see the Manual, at B.3.4.2.<br>Some countries use reference prices, replacing the transaction value with a reference price. Some countries may allow the reference price to be reasonably adjusted to reflect the specifics of the mineral.<br>Pricing must be properly evaluated before it can be said that the reference price is the answer. |

| Table V.1: (cont'd)   |                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|-----------------------|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Stage</b>          | <b>Industry</b>       | <b>Why is it an issue?</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | <b>How to deal with this?</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| 6. Abusive structures | Mining<br>Oil and Gas | <p>Reference pricing may be used for spot sales. Long-term customers generally pay a premium above the quoted reference price at the time the long-term contract is executed.</p> <p>There are structures where an intermediary service provider is interposed to purchase the commodity, often below the market price, and sell it to independent parties at a profit.</p> <p>This profit may then be made available to the principal, who instructed the agent to carry out the transactions for a commission fee. Most countries' transfer pricing rules seem to not apply in this situation.</p> | <p>Tax abuse provisions may be needed to tackle this issue or it should be considered whether the transfer pricing rules could be applied also to transactions of parties who do not fall within the definition of associated enterprises under domestic law.</p> <p>For example, Tanzania has a definition of related party/associate worded as follows: "in any case not covered by paragraphs (a) to (c) such that one may reasonably be expected to act, other than as employee, in accordance with the intentions of the other"<sup>c</sup></p> <p>Where reference prices have been introduced, assure that they apply to all transactions — related party transactions and unrelated party transactions.</p> <p>An alternative approach could be introducing and applying controlled foreign corporation rules (CFC rules) or to have legislation which allows for a review of a series of consecutive transactions.</p> <p>Reference is also made to Chapter 6 on the Tax Treatment of Decommissioning.</p> |

Table V.1: (cont'd)

| Stage                            | Industry              | Why is it an issue?                                                                                                                                                                                                                                                                                                     | How to deal with this?                                                                                                                                                                                                                                                                                  |
|----------------------------------|-----------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>G. Decommissioning</b>        |                       |                                                                                                                                                                                                                                                                                                                         |                                                                                                                                                                                                                                                                                                         |
| 1. Decommissioning services      | Mining<br>Oil and Gas | The price for decommissioning services provided by related parties may be overstated.                                                                                                                                                                                                                                   | See section A.3 of this table.                                                                                                                                                                                                                                                                          |
| 2. Sale or transfer of equipment | Mining<br>Oil and Gas | The equipment and infrastructure developed or purchased during the different stages of the project may still be functioning even though fully depreciated and having zero or close to zero value. The company may seek to sell or transfer this property close to the scrap or nominal value, rather than market price. | Use traditional TP Methods — CUP or alternative valuation. It should be considered whether alternative valuations can be used as an indicator for the arm's-length price. Reference is also made to the comment on the cost-only practices and the joint venture partners in section B.1 of this table. |

**a** Available at <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>.

**b** API stands for the American Petroleum Institute, which is the major United States trade association for the oil and natural gas industry. The API gravity is used to classify oils as light, medium, heavy, or extra heavy.

**c** Tanzania, Income Tax Act, S. 3(d).

*Considerations*

Fundamental to these findings is the fact that customers consisted of a number of long-term customers that were procured decades before by Parent company A, and that no additional customers were established and no other value is being created by Company B. All subsequent activities performed by Company B are of a management and marketing support nature.

The accounting flow of the transaction was different from the physical movement of the refined mineral.

As a result of the above determination, the profits attributed to Company B are not in line with the actual activities and need to be adjusted and reduced by applying the business profits article of the relevant tax treaty, in order to compensate Company B commensurate with the activities it performs.

See also table VI.1, section F.1, above.

***Example 2: Information challenges****Facts*

Company A is engaged in mining activities and being audited by the tax authorities in Country A, where the mining activities take place. The tax authorities of Country A wish to review the company's transfer pricing practices. Part of the audit questions by the Country A tax inspector include information regarding Company A's foreign related parties (taxpayer identification numbers, etc.). In response to the latter question, Company A informs the local tax inspector that the requested foreign information is unobtainable by the domestic tax authorities and confidential.

*Findings*

When pressed further as to why Company A believes that the foreign information does not have to be submitted, Company A mentions that because the obligation to provide that information is not explicitly included as required in domestic law, there is no legal requirement for Company A to submit that information.



### *Considerations*

In many cases, there might not be an agreement for the exchange of information (EOI) or a treaty for the avoidance of double taxation in place between Country A and the respective jurisdictions where Company A's related parties are located. Alternatively, if Country A participates in the Country-by-Country (CbC) report requirements under the OECD Base Erosion and Profit Shifting (BEPS) Action 13 regarding transfer pricing documentation, it may receive access to relevant foreign information.

Without these international instruments in place, the tax authorities need to make sure domestic law clearly allows for the request of such information and the obligation of taxpayers to provide such information. Tax authorities may also consider having rules in place that allow for presumptive taxation, where competitor information may be treated as indicative using Resale Price or Cost Plus Methods (see paragraph B.8.7. of the Manual) or taxation on a gross basis, if domestic companies cannot disclose information on payments made to related parties that under domestic law would otherwise qualify as deductible expenses.

### ***Example 3: Management services***

#### *Facts*

Company A conducts mining activities in a developing country and receives management services from related Company C, which is located in a low-tax jurisdiction. Company C charges its services out to the entire mining group, including Company A.

The tax authorities of Country A audit Company A as regards its related party transactions, in particular as regards the (price for) services rendered by Company C to Company A.

#### *Findings*

During the audit of Company A by the tax authorities of Country A, the management of Company A is being interviewed, and after a benefit test is applied for the services from Company C by the tax authorities of Country A, they conclude as follows:

- Company A did not request any services from Company C;
- No meetings were held to review the services requested and supposedly received from Company C;
- No records were provided of the respective services to Company A; and
- Company A arguably performed these services themselves internally (i.e., the services may be duplicative).

### *Considerations*

To determine the arm’s-length nature of such charges, first the benefit test should be applied to ensure that the services are chargeable. Next, the most appropriate TP method (CUP, Cost Plus or TMNN based on cost) ought to be considered, while focusing on verifying how the components of the cost base were established. To the extent the service charge consists of allocated costs, the allocation key for charging the costs needs to be reviewed. See also paragraphs B.4.3.5 – B 4.3.9 of the Manual. A service fee calculated as a percentage of sales may not be appropriate as it may overcompensate the costs. Typically, payment for services would be calculated by reference to the cost of the actual services provided. This may require an allocation of group costs among operating entities based on allocation keys.

For purpose of the allocation of a pool of costs, an appropriate allocations key should be used. Reference is made to paragraph B.4.4.19 of the Manual for examples of appropriate allocation keys.

### **Value chain for mining and minerals extraction**

The value chain of mining and minerals extraction depends on the specific mineral commodity involved and the type of mining needed to extract the mineral depending on whether the mineral is available above ground or underground.<sup>194</sup> The transformation of minerals

---

<sup>194</sup> Reference can be made to IMF, OECD, UN and WBG, “Supplementary Report—Addressing the Information Gaps on Prices of Minerals Sold in an Intermediate Form”, in *The Platform for Cooperation on Tax*, which was released as part of the *Platform’s Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses* (June 2017). The Supplementary Report provides guidance on identifying the types of mine

from the exploitation phase to the eventual trade, marketing and sale thereof typically follows a series of consecutive steps:

- (i) Acquisition and exploration;
- (ii) Construction and mine development;
- (iii) Mining, processing and concentration;
- (iv) Transportation;
- (v) Smelting and refining; and
- (vi) Trade, marketing and sales.

### ***Functions***

To undertake mining activities, companies will generally be designed to perform the following relevant functions:

- (a) Exploration for minerals;
- (b) Research and Development related to exploration and to provide related technical assistance services;
- (c) Financing of activities;<sup>195</sup> and
- (d) Marketing and trading of commodity products, which may or may not include shipping and distribution.

Usual functions, like headquarter functions, insurance, and other services (such as those related to information technology and human resource management) will also be performed by (some of the) separate entities of a MNE.

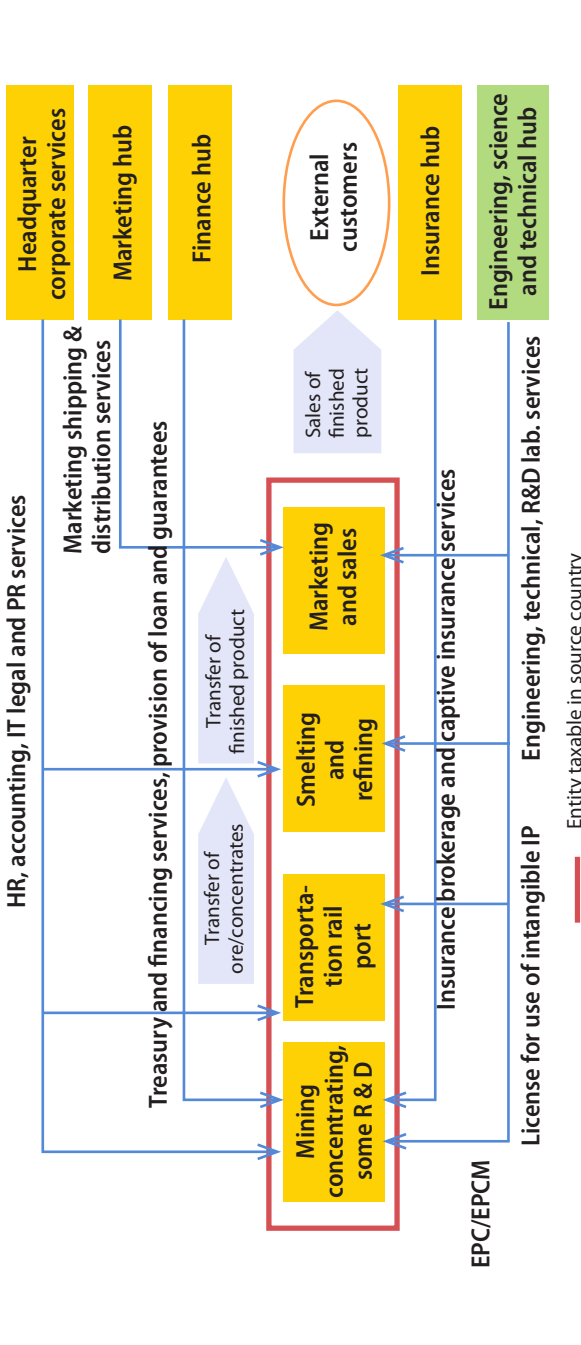
It should be noted that countries that grant licences for mining and extraction of minerals usually have a requirement that different activities performed by the mining company are treated as separate taxable objects and as separate taxpayers. They are ring-fenced, which means that for tax purposes the income and expenses and tax base of the activities are determined separately for separate projects (horizontal ring-fencing) or that different types of activities (e.g., extraction,

---

and production methods. Available at <http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>.

<sup>195</sup>Ibid. The document also provides guidance on financing arrangements affecting transacted product prices.

Figure V.1:<sup>a</sup> Diagram of vertically integrated mining operation, including relationship with service provider hubs.<sup>b</sup>



<sup>a</sup> Pietro et al., *Transfer pricing in mining with a focus on Africa*

<sup>b</sup> Modified from the Transfer Pricing Handbook for the Mining Industry (Transfer Pricing Associates, 2012).

processing, etc.) are treated differently from other type of activities (vertical ring-fencing). The legal form in which the mining or mineral extraction activities are performed in the host country is more often that of a local subsidiary/corporate body, rather than through a branch of a foreign company. The shares of the local entity may or may not be partially owned by the local authorities.

To perform a transfer pricing analysis of companies engaged in mining and minerals extraction, tax authorities need to get a thorough understanding of the functions performed, the assets used and risks borne by the respective MNE entities involved. For more details on conducting a functional analysis, reference can be made to paragraph B.2.3.2.7. on functional analysis of part B.2. (Comparability Analysis) in the Manual.

The form within which a fully vertically integrated mining operation is conducted may be fairly straightforward, but the allocation of functions, assets and risks relevant to operate in the mining and mineral extractive industry within an MNE may be diverse. To get a better understanding of the step-by-step process pursuant to which copper, iron ore, thermal coal and gold are mined, reference is made to the Platform for Collaboration on Tax Toolkit.<sup>196</sup>

A MNE is likely to obtain services and products both from related parties and unrelated suppliers. Getting a proper understanding of whether parties with which the MNE conducts business are associated and therefore subject to the arm's-length standard of Article 9 (Associated Enterprises) of the United Nations Model Convention may present a challenge. Furthermore, through location of functions in the supply chain outside of the country where extraction takes place, MNEs may be able to allocate profits abroad.

### ***Assets***

Assets that can be considered and used by the MNE operating in mining and minerals extractive are listed in the table below. For more details on the importance of assets within an MNE for transfer pricing purposes, reference can be made to paragraph B2.3.2.17 in the Manual.

---

<sup>196</sup> Available at <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>.

Table VI.2:<sup>a</sup>  
Typical assets of a mining company

| Exploration Discovery                                  | Mine Development and Construction                             | Mine Exploitation                                                                                                                            | Beneficiation, Smelting and Refining                             | Trading, Marketing and Sales                  |
|--------------------------------------------------------|---------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------|-----------------------------------------------|
| Exploration and mining licenses and rights, (I)        | Engineering design (I)                                        | Exploitation techniques (I)                                                                                                                  | Beneficiation processes (I)                                      | Customer lists and relationships (I)          |
| Access and surface rights (I)                          | Engineering machinery (T)                                     | Exploitation plant and equipment and infrastructure (T)                                                                                      | Beneficiation plant and equipment (T)                            | Marketing and distribution activities (I+T)   |
| Drilling rights                                        | Engineering, procurement and project management know-how (I)  | Logistics management and infrastructure (I+T)                                                                                                | Logistics management and infrastructure (I+T)                    | Logistics management and infrastructure (I+T) |
| Exploration and laboratory equipment and machinery (T) | Construction, drilling and excavation plant and equipment (T) | Transportation plant and equipment and infrastructure (T)                                                                                    | IP relative to the smelting/refining processes and protocols (I) | Shipping and warehousing (T)                  |
| Topographical surveys (I)                              | Construction camp and logistic infrastructure (T)             | Value of mineral resources and reserves included in price of acquisition of mining rights from a third party (not by means of discovery) (I) | Smelting and refining plant and equipment (T)                    | Product stocks (T)                            |
| Geological surveys (I)                                 | Mine development (T)                                          | Broken ore stockpiles and inventory (T)                                                                                                      | Ore, concentrate and metal stockpiles and inventories (T)        | Marketing know-how (I)                        |

|                                                                                                   |                                                                                                    |  |  |                                                                   |
|---------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|--|--|-------------------------------------------------------------------|
| Geochemical surveys (I)                                                                           |                                                                                                    |  |  | Trading software/<br>platforms (I)                                |
| Geophysical surveys                                                                               |                                                                                                    |  |  | Specialized aspects<br>of supply chain man-<br>agement (I)        |
| Transport, communi-<br>cation and camp faci-<br>lities (T)                                        |                                                                                                    |  |  | Product innovation<br>processes (I)                               |
| Exploration techniques<br>and know-how (I)                                                        |                                                                                                    |  |  | Distribution rights<br>(I)                                        |
| IP related to remote<br>sensing and GIS tech-<br>niques and related<br>databases (I)              |                                                                                                    |  |  | Pricing negotiations<br>know-how for un-<br>usual commodities (I) |
| IP related to negotia-<br>tion, contract structu-<br>ring and management<br>of joint ventures (I) | IP related to nego-<br>tiation, contract<br>structuring and<br>management of joint<br>ventures (I) |  |  |                                                                   |

I = Intangible asset, T = Tangible asset, I + T = Intangible and tangible assets

**a** Pietro Guji, Stephanie Martin and Alexandra Readhead, *Transfer pricing in mining with a focus on Africa: a briefing note* (Washington, D.C., World Bank Group, German Cooperation Deutsche Zusammenarbeit, Centre for Exploration Targeting, 2017). Available at <http://documents.worldbank.org/curated/en/2113881485941701316/pdf/1112344-REVISED-Transfer-pricing-in-mining-with-a-focus-on-Africa-a-briefing-note-Web.pdf>.

**Risks**

Some of the relevant risks that an MNE operating in the mining and minerals extractive industry may incur can be external or internal and are summarized in the table below.

For more details on the importance of risks within an MNE for transfer pricing purposes, reference can be made to paragraph B2.3.2.22. and onward in part B.2. of the Manual.

**Industry-related case examples**

Following is a compilation and series of case examples regarding issues and facts encountered in practice with respect to mining and mineral extractive industries.

***Example 1: Export of low value minerals to an intermediary distribution company******Facts***

Physical commodities are shipped directly from the Mining Company to the third-party customer. However, the invoice flow is from the Mining Company to an intermediary group Distribution Company C located in a low-tax jurisdiction and then on towards the third-party customer.

The transfer price between the Mining Company and intermediary Distribution Company C is determined with reference to an index price or reference price for the commodity, less a distribution/marketing margin for the functions performed by the intermediary group Distribution Company C.

In this scenario there are two pricing issues to evaluate:

- (a) The point in time the reference price is determined compared to when it is calculated in an arm's-length situation;
- (b) Whether the distribution/marketing margin is at arm's length. The CUP method may be appropriate for the purposes of determining whether the reference price (number (i) above) applied in the transfer pricing between Mining Company and intermediary Distribution Company C is at



Table IV.3:  
Risks typically encountered by a mining company

| Risks                                           | Acquisition/<br>Exploration | Mining | Ore<br>Processing | Trade | Marketing/<br>Sales |
|-------------------------------------------------|-----------------------------|--------|-------------------|-------|---------------------|
| Exogenous                                       |                             |        |                   |       |                     |
| Market risk                                     | —                           | x      | x                 | X     | X                   |
| Currency/foreign exchange risk                  | X                           | X      | x                 | x     | x                   |
| Social/political sovereign/legal risk           | X                           | X      | x                 | —     | —                   |
| Natural disaster risk                           | X                           | X      | x                 | —     | —                   |
| Environmental risk                              | X                           | X      | x                 | —     | —                   |
| Endogenous                                      |                             |        |                   |       |                     |
| Exploration risk                                | X                           | —      | —                 | —     | —                   |
| Operating risk                                  | x                           | x      | x                 | x     | x                   |
| Processing risk                                 | —                           | X      | X                 | —     | —                   |
| Capacity underutilization and availability risk | —                           | x      | x                 | x     | —                   |
| Transportation risk                             | —                           | X      | X                 | X     | X                   |
| Inventory risk                                  | —                           | X      | X                 | X     | X                   |
| Product liability risk                          | —                           | X      | X                 | X     | X                   |
| Credit risk                                     | —                           | X      | X                 | X     | X                   |
| Source: TPA Global                              |                             |        |                   |       |                     |

— = Limited risk, x = Moderate risk, X = High risk

arm's length. However, for the purpose of the distribution/marketing margin (number (ii) above) the CUP Method may not be appropriate if the intermediary Distribution Company C performs substantial marketing/distribution functions.

### *Findings*

It was found that despite the fact that the sale of the commodity is on a back-to-back free-on-board (FOB)/cost, insurance and freight (CIF) (or "flash title") basis from the Mining Company to the intermediary Distribution Company C to the end customer, the pricing between the parties in the supply chain are determined at different points in time. The production sale price from Mining Company to related party intermediary Distribution Company C was determined at the index price of the month prior to shipment, while the related party intermediary sales price to end customer is determined at the index price at the month of shipment (i.e., later in time).

### *Considerations*

The difficulty faced in this scenario is to get documentation/benchmarking data that can assist in the evaluation whether, in a back-to-back (flash title) sales transaction, the producer's sale price (at index price prior to shipment) is at arm's length.

For more information on pricing practices, also consult the Supplementary Report.

## ***Example 2: Coal group marketing activities***

### *Facts*

The Coal group is involved in the mining, production and distribution of coal. The entities within the group perform research, development, marketing, sales, shipping and distribution of coal.

Coal Company is a tax resident of a developing country. The company owns several mines and is involved in the exploration, development and mining of coal. The coal that is produced by Coal Company is used for electricity generation and more than 90 per cent of Coal Company's revenue relates to coal that is exported.

Marketing Company is incorporated under the laws of a low-tax jurisdiction. Marketing Company entered into a distribution agreement with Coal Company for all coal produced by Coal Company that is suitable for export.

According to a legal agreement between Coal Company and Marketing Company, Marketing Company is responsible for sourcing customers, contract negotiations, delivery of coal to end customers and exploiting the market for coal. It also bears inventory, credit, quality, price, foreign exchange and delivery risk. As consideration for the functions and risks borne, Marketing Company earned a gross margin of 7 per cent. Marketing Company is described as a fully-fledged distributor.

The key value drivers in this industry are considered to be:

- Ability to blend different coal qualities to match customer requirements;
- Coal specifications, for example the higher the caloric value and lower the impurities, the higher the expected price per ton;
- Prompt delivery to end customers; and
- Freight rates.

Marketing Company does not have any technical sales personnel. Coal Company is responsible for blending coal according to customer specifications. Customers inform Marketing Company of their need for blending and it passes the request to Coal Company to do the actual blending. Marketing Company does not hold inventory and takes flash title to the goods. At Marketing Company's request, Coal Company can liaise directly with the end customer to organize delivery of coal.

The market has changed drastically over the years. There has been a change in the grade of coal required by customers due to an economic downturn, environmental laws, availability of substitutes and increased number of sellers in the market. This has put pressure on coal suppliers to come up with innovative ways to retain their position in the market. The expertise of Coal Company's technical team is required to evaluate the changes to coal specifications and ensure that the group achieves high margins.

Marketing Company has four employees. Based on the documentation reviewed and interviews conducted, only two of these employees

are responsible for marketing the coal. Marketing Company entered into an agreement with Advisory Company, a related party marketing agent, located in the same country as Marketing Company. According to this agreement, Marketing Company outsourced all of its marketing functions to Advisory Company as it did not have the necessary skills and resources to fully market the coal bought from Coal Company. For the service it provides, Advisory Company receives a commission of 3 per cent on all sales by Marketing Company to third parties. A Resale Price Method was used in determining a margin of 7 per cent for Marketing Company.

### *Findings*

The Revenue Authority in Country A is of the view that 7 per cent is excessive and Marketing Company should have been classified as a limited risk distributor. According to the benchmarking study performed by the Revenue Authority in County A, comparable entities earn gross margins of between two and four per cent.

### *Considerations*

From the background presented above, the following should be considered:

- (a) What factors influence the sale of coal? Obtain an understanding of the coal industry and the economic environment in which the taxpayer is operating;<sup>197</sup>
- (b) The terms of the distribution agreements: Are they comparable to third-party distribution agreements? If they are not, this forms a basis for a transfer pricing adjustment;
- (c) Obtain a clear structure of the group and an understanding of the supply chain. Understand the transactional flow of invoices and physical flow of goods;
- (d) The above step should be followed by delineating the actual transaction and allocating functions, assets and risks to each company in the supply chain. Does the conduct of parties differ from the legal agreement?;

---

<sup>197</sup> Please note that the *Platform's Supplementary Report* includes an extensive example explaining thermal coal mining, markets and trading, pricing and contractual arrangements.

- (e) Who manages the risk and has the financial capacity to bear the risk? Which entity in the supply chain is ultimately liable to third parties? It is important to understand where value adding activities are conducted and managed as this is where economic functions should be allocated;
- (f) Review internal comparables, and if they exist, consider whether reasonable adjustments can be made; and
- (g) What is the appropriate transfer pricing method to select? Does external data exist? If it does, perform a benchmarking study where comparable entities are identified.

***Example 3: Price fluctuations and intermediary sales of uranium***

*Facts*

Company A operates a uranium mine in developing Country A. Upon extraction, Company A sells the mined uranium to a related Swiss marketing entity at an output kilogram price that reflects the long-term commodity price, which is agreed to in the related party distribution agreement.

Because of external developments, the uranium price decreased to 30 per cent of the price agreed between the related mining company and its intermediary sales company.

*Findings*

Upon audit, the tax authorities question the use of the long-term commodity price between related parties, as it does not seem to consider who carries the risk of loss when commodity prices fluctuate and (as in this case) drop. There is no benchmark made available to help substantiate the income allocation between the related parties.

*Considerations*

At issue is whether the price set between the related parties qualifies as being at arm's length, considering the facts and circumstances at the time the contract was entered into. Would independent parties have agreed on an adjustment clause in case of changing market circumstances?

What is the custom in the business? Tax authorities have to be careful in using a hindsight analysis. Is the risk of loss (or gains) upon price fluctuations allocated to the party that can best handle, manage and control the risks, when market conditions change? For example, did any of the parties enter into hedging agreements to mitigate price fluctuations?

To analyse these facts, it is important to consider the market environment. For example, in this particular industry, if there is an undersupply of smelting services, a price participation agreement may be appropriate.

#### ***Example 4: Market off-taker function***

##### *Facts*

Company B is located in Country B, a low-tax jurisdiction. Pursuant to an off-take agreement with related Company A in developing Country A, Company B is obliged to buy 100 per cent of the coal produced by Company A.

The off-take agreement between Company A and Company B does not include a guarantee on price. The pricing will be based on current market prices minus a discount reflecting the risk assumed by Company B for the (100 per cent) off-take obligation. Company B takes flash title to the coal it off-takes from Company A and therefore does not carry inventory risk.

##### *Findings*

The tax authorities of Country A challenge the discount to the market price that Company B receives when buying coal from Company A, as Company A is in a position to adjust its production based on market supply and demand conditions.

The mining group takes the position that the discount ought to be higher than that given to independent, fully fledged distributors, to reflect the risk it takes in the off-take agreement.

##### *Considerations*

The tax authorities should review whether the market off-taker (Company B) really assumed these additional market risks, in

particular considering that Company A adjusts its production based on the market conditions. Furthermore, the pricing is based on the current market price and volume risk is managed by Company A, now that the mining company adjusts its output to reflect supply conditions in the market.

### ***Example 5: Buying and selling of iron***

#### *Facts*

The taxpayer is resident in a developing country that has a relatively low corporate tax rate, and is engaged in the business of buying and selling raw materials (iron). The taxpayer has an associated Headquarters company in Europe and a direct Parent company, which is a holding company in the Middle East.

The taxpayer buys iron from associated enterprises in South America and sells the Iron to associated enterprises in Asia and the United States of America. About 80 per cent of the buying and selling of ore is being conducted in Asia. Getting information on the technicalities of this particular business has proven to be very difficult.

The taxpayer reports a markup of 0.5 per cent on cost on its inter-company buy-sell transactions. A comparison of companies that operate more or less in the same line of business shows margins between 10–15 per cent. Research also showed that the country of source of the iron provides a six-year tax holiday.

Additional challenges encountered in this case regarded getting information on the margins obtained with buying and selling that specific iron.

#### *Findings*

Even though the corporate tax rate in the developing country where the taxpayer is operating its buy-sell activities is 15 per cent, which is lower than the tax rates in many other countries, the MNE of which the taxpayer is a part would have a benefit in leaving taxable profit at the source of the location where the iron originates. This case scenario shows that a corporate tax rate of 15 per cent does not necessarily mean no transfer pricing irregularities will take place.

### ***Example 6: Intercompany financing***

#### *Facts*

The taxpayer is engaged in the exploration of minerals and mining.

The Parent company/Headquarter company is located in a developing country, with a US Holding company and two Africa-based mining and operation companies.

The Parent company has issued loans to its African subsidiaries, which carry no interest remuneration for the Parent company.

On the other hand, the Parent company borrows funds denominated in US dollars from associated enterprises for which it pays a London Interbank Offered Rate (LIBOR) plus 2.5 per cent interest rate.

Furthermore, the developing country-based Parent company pays a technical assistance fee to the two Africa-based mining and operation companies, based on the respective companies' salary cost, consulting costs, moving expenses of employees, and for providing technical services. The technical assistance fee is at a cost plus one-five per cent level.

Considering the absence of interest income yet the incurrence of interest costs and technical assistance fee costs, the developing country-based Parent company consistently operates at a loss.

The African mining company enjoys a tax holiday and other companies in the same industry normally report a cost plus four per cent.

#### *Findings*

This case example presents the difficulty of associated enterprises reporting ongoing losses, and the fact that it is a challenge to obtain data on intercompany financing activities and the conditions of intercompany financing.

The developing country in issue has signed the Agreement on Mutual Administrative Assistance in Tax Matters, but collecting relevant information from overseas remains very time-consuming, in particular as transactions tend to be spread out over several jurisdictions.



***Example 7: Copper JV****Facts*

A copper mine in Country M is owned and operated by a joint venture company, JV, organized under the laws of Country M. 45 per cent of the equity interests in JV are owned 45 per cent by Company A, a Country X subsidiary of a large mining conglomerate based in Country Y. 40 per cent of the equity interests in JV are owned by Company B, a Country X subsidiary of another large mining conglomerate that is based in Country Z. The remaining 15 per cent of the equity interests in JV are owned by Company C, an entity wholly owned by the Government of Country M.

JV has entered into service agreements with Companies A, B and C pursuant to which JV agrees to pay an annual fee equal to five per cent of its revenues to Companies A, B and C as compensation for any technical services that may be required to support the operation of JV from time to time. Under the agreements, the service fee payments are to be divided among the three recipients of the payments in proportion to the equity interests of Companies A, B and C in JV. Country M imposes a 10 per cent withholding tax on dividends but has a treaty arrangement with Country X that provides that service fees are not subject to withholding tax.

The Country M tax authorities audit the services arrangements between JV and Companies A, B, and C. They learn that Companies A and B each provide occasional services of a technical nature to JV. The services are provided by a combination of employees of Companies A and B and employees of their respective parent companies. The amount and nature of the services provided varies substantially from year to year, but the tax authorities are told that JV has no available information regarding the costs incurred by Companies A and B in providing the services and that no specific invoices for particular services are provided. Instead there is merely a single annual invoice for the five per cent of revenue payment. The Country M tax authorities learn further that Company C has never provided services of any kind to JV.

*Analysis*

The first step in conducting a transfer pricing analysis of the relationships between Companies A, B, and C and JV is to accurately delineate the transactions. In doing so, the Country M tax authorities determine that there is a service arrangement between Company A and Company B and JV. However, the amount and nature of services provided cannot be determined based on the available information. The Country M tax authorities determine that no services arrangement actually exists between Company C and JV.

Since there is no evidence of the type and amount of services provided, the Country M tax authorities determine that without further information they are unable to determine whether the actual services provided by Companies A and B satisfy the requirements of the benefits test described in paragraph B.4.10. of the Manual. They therefore conclude that, unless further information regarding the nature of the specific services is provided, no deduction should be allowed for the five per cent fee and that it should be properly characterized as a distribution of profits to the holders of equity interests in JV.

***Example 8: Sale and leaseback of equipment****Facts*

Five years ago, Mining Company in Country G acquired a fleet of dump trucks to transport the ore it mined from the mine site to its nearby beneficiation plant. In accordance with Country G's accelerated depreciation provisions, Mining Company depreciated the capital costs of the trucks over five years. At the end of the five-year period, Mining Company sells the fleet of trucks to Equipment Company, an associated enterprise of Mining Company, located in Country X, a low-tax jurisdiction. The sales price received by Mining Company from Equipment Company is equal to the written down value of the trucks.

Immediately after the sale, Mining Company enters into a five-year operating lease with equipment Company to lease back the fleet of trucks. Mining Company pays an arm's-length rent to Equipment Company for the use of the trucks.

### *Findings*

Mining Company has recorded depreciation deductions against the acquisition costs of the fleet of trucks. The sale of the fleet at their written-down value means that Mining Company records no capital gains upon the transfer of the asset. Under the lease arrangement, Mining Company can record deductible rent payments for the use of the same fleet of trucks it owned earlier and depreciated.

### *Considerations*

The hiring or acquisition of equipment can be problematic. Here, Mining Company has mining equipment. It depreciates the asset and then sells it to related party Equipment Company in Country B. Country B records it as a new asset as opposed to a second-hand asset and it is re-depreciated all over again in Country B. This form of tax planning may in itself not be a transfer pricing issue, but considers whether the transaction is a bona fide sale or bona fide lease. In this respect, reference is made to paragraphs B2.3.1.4–B2.3.1.9 of the Manual. It should be considered for transfer pricing purposes whether the sale value is inflated (if so, there will be a recoupment in Country A). Also, the customs value may be under-declared to avoid high tariffs (the shipping value is not always checked against the sale value); this creates room for arbitrage and generates tax benefits.

### **Value chain for the production of oil and natural gas** <sup>198</sup>

The oil and gas exploration business is a high-risk global industry, but when particular projects are successful the reward is potentially very high. In most countries, governments own the subsurface oil and gas. Rather than trying to extract these natural resources themselves, governments see value in bringing in specialized oil and gas companies to take on those activities. The main reason for this is to balance risks and rewards. Exploration and Production (E&P) contracts describe the rights and responsibilities of the investor and also entail the share

---

<sup>198</sup>For more information, see Silvana Tordo, Brandon S. Tracy and Noora Arfaa, “National Oil Companies and Value Creation: Study and Results”, in *World Bank Working Paper 218* (Washington, D.C., World Bank, 2011). Available at <http://go.worldbank.org/UOQSWUQ6P0>.

of production and or revenues that have to be paid to the government. These contracts usually come in the form of either concessions or production sharing contracts.

E&P contracts reflect a fine balance between International Oil Companies (IOCs) and developing-country governments, their aspirations and expectations. In collaboration with natural resource owners, IOCs are prepared to accept numerous risks associated with a project, such as (i) exploration risks (i.e., whether oil and gas reserves can be found in commercial quantities); (ii) development risks (i.e., the technical risks associated with the physical investment needed to produce and transport production to market); (iii) economic risks (the upfront capital outlays required prior to production and the ongoing operating costs of the project); and (iv) market risks (the price and supply/demand risks over a very long project life).<sup>199</sup> In return, the IOCs expects (a) a fair risk/reward relationship; (b) a fair rate of return on capital; and (c) as much certainty as governments can provide with respect to fiscal and legal terms. Content of the contracts can vary depending on the prevailing energy prices, demand for hydrocarbons and availability of funds for investments.

### ***Upstream, midstream and downstream activities***

The value chain of production of oil and natural gas commences with identifying suitable areas to conduct exploration for oil and/or gas, and continues with upstream activities, consisting of exploration, development and production of crude oil and natural gas (this may include oilfield-related activities such as seismic surveys, well drilling and equipment supply or engineering). As with mining, the oil and gas industry requires significant upfront capital investments, but the upstream activity (i.e., the exploration risk in the oil and gas industry) tends to be riskier than in the mining industry.

So-called midstream activities in this industry include those related to the necessary infrastructure and storage to be able to refine the oil and process the gas. Processed products are subsequently

---

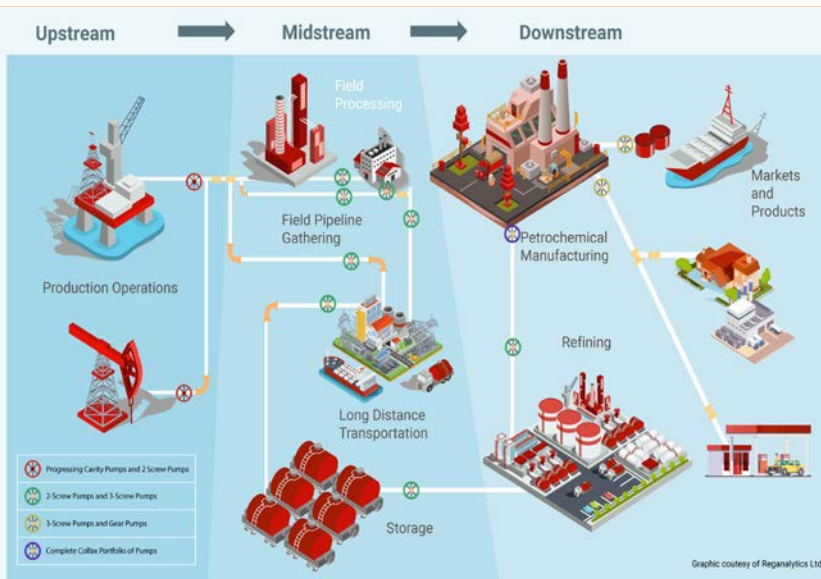
<sup>199</sup>A more complete discussion of risks, including references, can be found in Chapter 1 (Overview) of this Handbook.

distributed towards wholesale and retail; this part of the business is described as consisting of “downstream” activities. This includes the transport of the product via pipelines or oil tankers, refining and wholesale and/or retail sales. Midstream activities are often included in the downstream processes.

The figure below presents an overview of the respective upstream to downstream activities:

Figure V.2:

### Upstream, midstream and downstream activities in the extractive industries



Source: Reganalytics Ltd

The functions performed, assets used and risk exposure of companies engaged in the oil and gas industry will differ depending on the type of contract that the company has entered into with the host country where the oil and gas reserves are located, as follows:

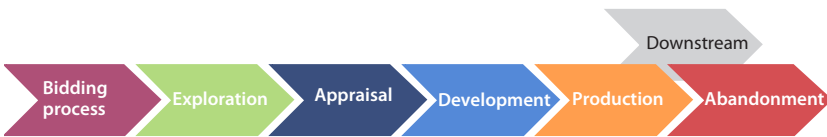
- (i) In a concessionary system, the oil company, as licensee, obtains a lease for a fixed period of time from the government and is responsible for all investment in and generally owns all exploration output and production equipment

subject to making royalty, tax and other licence payments to the government;

- (ii) Under a production sharing contract, the production and reserves in the ground usually are owned by the State (or the national oil companies) with which the company has contracted, whereas the company (fully) funds the development of the oil and gas production. Part of the produced oil and gas serves as reimbursement for the company’s investments and part of the produced oil and gas will be shared between the State and the contracting company;
- (iii) Under a service contract, the contracting company is usually paid a service fee for providing the service of producing oil and gas on behalf of the host State. The contracting company usually provides all capital associated with exploration and development without any claim to ownership of reserves or production. However, part of the sales revenue of the oil and gas will be applied to reimburse the contractor’s costs and pay its service fee.

The figure below provides for a generic overview of the upstream oil and gas industry value chain:

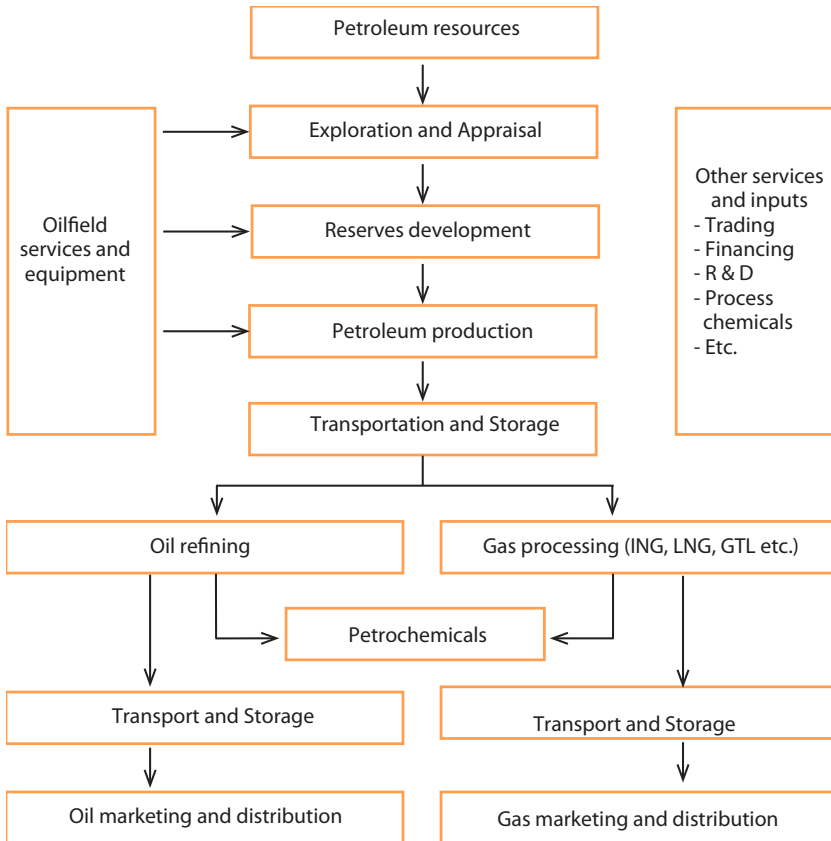
Figure V.3:  
**Upstream oil and gas industry value chain**



Source: UN/DESA.

Below is a more detailed overview.<sup>200</sup>

<sup>200</sup> Silvana Tordo, Brandon S. Tracy and Noora Arfaa, “National Oil Companies and Value Creation: Study and Results” in *World Bank Working Paper 218* (Washington, D.C., World Bank, 2011). Available at <http://go.worldbank.org/UOQSWUQ6P0>.

Figure V.4:<sup>a</sup>**Petroleum value chain**

<sup>a</sup> C. Wolf, *Does Ownership Matter* (2009)

The valuation of crude has been an area of contention in the past, when many IOCs traded the produced crude with their downstream organizations often at low transfer prices. Host governments in the producing countries assumed that the price was kept artificially low to reduce upstream taxation and therefore they introduced a posted price or a tax reference price. As there are now clear indices on international crude prices, this hand-off point to downstream business can be benchmarked.

## Industry-related case examples

Due to its nature, the oil and gas industry presents specific transfer pricing issues. Some of these industry-specific aspects are shared with the mining and extractives industry and are identified in Table VI.1, listing consecutive phases that extraction of minerals may involve. Other oil and gas industry issues that may be relevant from a transfer pricing perspective include:

- Central operating model;
- Financing cost;
- Intra-group guarantees;
- Cost sharing;
- Group synergies;
- Charging at cost; and
- Ring-fencing.

To the extent possible, these issues are listed/identified in Table VI.1 addressing the consecutive phases that may be involve in the extraction of minerals may.

Following is a compilation and series of real-life case examples regarding issues and facts encountered in practice with respect to the oil and gas industry.

### *Example 1: Oil acquired from related companies*

#### *Facts*

Fuel Company is engaged in the blending and refining of crude oil to produce fuel that is sold to consumers in Country A. Imported crude oil is a very important element required to produce fuel sold by Fuel Company.

Fuel Company purchases crude oil from its wholly owned subsidiary, Shipping Company, which is incorporated in and tax resident of Country B. Shipping Company purchases crude oil from Sourcing Company, incorporated and tax resident of Country C (a low-tax jurisdiction).

Sourcing Company acquires crude oil from unrelated third parties in Countries D and E.



Shipping Company and Sourcing Company are both wholly owned subsidiaries of Fuel Company.

### *Findings*

Upon review of the facts and intercompany agreements, it becomes clear that Sourcing Company has long-term contracts for the purchase of crude oil from unrelated parties in Countries D and E. Sourcing Company sells the crude oil to the related Shipping Company on an FOB basis. Shipping Company is responsible for all freight and related activities and sells the crude oil to related Fuel Company on a CIF basis. Crude oil is loaded at the ports in Countries D and E and delivered in Country A at the port near Fuel Company's facilities. In the past, Fuel Company used to acquire crude oil directly from third parties in Countries D and E.

### *Considerations*

As Sourcing Company is resident in and operates from a low-tax jurisdiction, there is an inherent risk that the group profits may be diverted to that jurisdiction with the effect of reducing the tax liability of the group and eroding the tax base of the Fuel Company.

It is assumed that the price paid by Sourcing Company to the unrelated third parties for the purchases of crude oil is a market price. Should the terms and conditions of the contracts between Sourcing Company and Shipping Company, and between Shipping Company and Fuel Company not reflect terms and conditions that would have been agreed upon in a contract between independent unrelated parties (not at arm's length) Fuel Company could end up paying an inflated price for the purchase of crude oil from the related Shipping Company.

The result is that the tax base of the country in which Fuel Company is resident is eroded by the inflated price paid for the crude oil purchases. Controlled foreign company rules could be applied to tax the profits made by Sourcing and Shipping companies as a result of mispricing of the transactions between Sourcing Company and Shipping Company as well as between Shipping Company and Fuel Company.

As Sourcing Company and Shipping Company are subsidiaries of Fuel Company, they are controlled companies and should be within

the scope of domestic controlled foreign corporation (CFC) rules, if those are in place. If applicable CFC rules cover situations where goods are purchased from third parties located in third countries for on-sale to the resident country, then the profits arising from those transactions could be imputed to Fuel Company and included in the taxable income of Fuel Company. These diversionary rules would tax the full profit of the CFC from the diversionary activities performed by the CFC.

***Example 2: Structure and operations of a company in the petroleum industry, which could lead to practical transfer pricing issues***

*Background*

The petroleum industry includes the global processes of exploration, extraction, refining, transporting (often by oil tankers and pipelines) and marketing of petroleum products. Petroleum (oil) is also the raw material for many chemical products, including pharmaceuticals, solvents, fertilizers, pesticides, synthetic fragrances and plastics.

*Structure*

The “Company” is in the Petroleum Industry and one of the major players involved in upstream as well as downstream activities. The Company is incorporated in Country A, but headquartered in Country B. The Company does not carry out any operational activities, but has a board that oversees the activities of the Group. The business model is that of a vertically integrated company that provides significant economies of scale and barriers to entry, each business seeks to be a self-supporting unit without subsidies from other parts of the company.

The Group is comprised of four Holding Companies for different regions, Operating Companies for each country, and Service Companies providing shared services to the operating companies.

The upstream business tends to be more centralized with much of the technical and financial direction coming from the central offices in Country D.

Currently nearly all of the operations in various businesses are much more directly managed from Country D. The “autonomy” of

the local structures has been removed, with a more global approach being created.

### *Upstream business*

The Company's upstream activities relate to worldwide exploration activities for crude oil and natural gas. Due to the lengthy time period (of up to five years) and the expensive nature of this exercise, exploration activities are commonly conducted in partnerships with various role players, including the governments of the countries in which the exploration activities are happening. Exploration activities are taking place on land and sea and are usually conducted on an outsourced basis to independent third parties that specialize in this field. Expenses relating to exploration activities are allocated to existing production upstream companies in the explored territory.

### *Exploration*

A subsidiary of the Company called Explore 1 is based in Country C (a low-tax jurisdiction). Explore 1 is responsible for coordinating the various types of exploration activities on land and sea. Explore 1 is further responsible for the tenders for exploration blocks and also manages the interaction with the relevant government departments of the effected countries.

Explore 1 on-charges all of its costs, with a 20 per cent markup per explored territory to the upstream production company of the relevant territory. The markup percentage is based on inherent risks the exploration company is taking in terms of the coordination activities and country risk issues. The costs charged by Explore 1 have the potential of eroding the tax base of the resident country.

The allocation of the costs and the markup charged by Explore 1 should probably be investigated by the tax authority of the Upstream Company for the following reasons:

- a. Explore 1 is an entity operating from and resident of a low-tax jurisdiction. This means there is an inherent risk that the group profits may be diverted to that jurisdiction with the effect of reducing the tax liability of the group and eroding the tax base of the production company. It is important to

- determine whether Explore 1 actually performs its functions and assumes the risks it is said to perform.
- b. The allocation of costs should be investigated to ensure that the correct costs are allocated to the resident Upstream Company and not only to Upstream Companies already in operation with taxable revenue.
  - c. The allocation of costs should further be investigated in terms of capital versus revenue, depending on the resident country's taxation rules on deductibility of start-up capital expenditure.
  - d. The high markup should be investigated, as Explore 1 is essentially a service company with coordinating activities. Explore 1 assumes no risks as all costs are essentially charged out.

### *Evaluation and finance*

Once a positive source is identified, it is evaluated via geochemistry methods to quantify the nature of organic-rich rocks, which contain the precursors to hydrocarbons. After a hydrocarbon occurrence has been identified and appraised it is sent to Finance 1, a subsidiary of the Company based in Country D. The finding is then evaluated using various factors, taking into account economic, political and geopolitical factors. This also means that the fiscal regime of the relevant country is evaluated (for example, the government participation rights, deductibility of capital expenditures, ring-fenced losses, fiscal stability agreements and royalty rates).

Finance 1 is responsible for the financing of the development phase or meeting any other capital requirements once in the production phase. The development could either be financed through available group finance or external financing. The choice between internal and external financing is evaluated taking various factors into consideration. The factors include the overall expected return on the project, any participation rights of the relevant government, and the fiscal regime of the country. Finance 1 then borrows the money either internally or externally and lends it out at a premium of two per cent higher than the Group's internal rate of return of the previous year. This has the effect that any interest paid by the relevant companies in the Group is nearly

always higher than the central bank rate of the specific country. The gearing of the Upstream Companies, due to intensive capital expenditure at the start-up stage, is extremely high, usually at a one-to-six ratio of equity to debt. The premium compensates Finance 1 for both a return on monies lent and for the evaluation of the original project. The development phase to production can take up to three years.

The thin capitalization of the Operating Company and interest rate charged by Finance 1 results in eroding the tax base of the operational resident country. In terms of the borrowing and interest charged by Finance 1, the tax authority of the country where the Company is resident should probably investigate the ratio of debt to equity of the resident Company.

A company is said to be thinly capitalized when the level of its debt is much greater than its equity capital, i.e., when its gearing, or leverage, is very high. Thin capitalization rules typically operate by means of one of two approaches by a revenue authority:

- Determining a maximum amount of debt in relation to which deductible interest payments are available; or
- Determining a maximum amount of interest that may be deducted by reference to the ratio of interest (paid or payable) to another variable.

Depending on the specific rules of the resident country the debt to equity ratios should be calculated and/or the interest rate charged by Finance 1 and the amount of interest paid.

### *Downstream business*

Downstream business relates to a number of different activities, in an integrated value chain, that collectively turn crude oil into a range of refined products. Products can include gasoline, diesel, heating oil, aviation fuel, marine fuel, liquefied natural gas, lubricants, bitumen, sulphur and liquefied petroleum gas. These products are moved and marketed around the world for domestic, industrial and transport use.

### *Crude purchases*

Trading Company 1 in Country C (a low-tax jurisdiction) sells crude oil to Operational Companies with refineries situated worldwide.

Trading Company 1 has several trading desks operated by specialists and is regarded as conducting a genuine business. Trading in crude is of a high-risk nature due to the volumes traded per deal and the relatively small margins per barrel. The trading system is largely computerized and equipped with interfaces with the operating companies.

The operating companies with a refinery located in various different countries would typically contact Trading Company 1 via the computerized interface for the relevant desired type and grade of crude. Each refinery has different requirements of crude grades and origin depending on the type and age of the refinery.

The trading subsidiary in Country C would then enter into term supply contracts or spot purchases for crude based on the requirements of the refineries. These agreements could be made between the Company's own upstream operational companies or independent third parties. The Trading Company then sells the crude to the operational companies.

The Trading Company also manages the logistics of the entire process and arranges transportation using either an external party or the Company's own shipping company, depending on the circumstances. The Trading Company charges a premium ranging from \$1 to \$5 for every barrel of crude oil sold to the operating companies for the logistics.

This premium charged by Trading Company 1 erodes the tax base of the operational companies in their resident countries. In terms of the premium charged by Trading Company 1, the tax authority of the Operational Company should probably investigate the following:

The price per barrel paid should be compared to the relevant daily market-related data of crude products depending on the origin of the crude. A premium is charged by Trading Company 1 per barrel of crude purchased by the operational Companies. As the average deal amounts to 350,000 barrels of crude, a substantial profit is made by Trading Company 1. Deviation to the daily published prices should be investigated to determine the nature thereof.

*Transport of crude*

The Company's shipping arm is registered in Country B and owns several oil tankers able to transport crude or refined petroleum products in various volumes. Ship sharing is not uncommon when different petroleum companies share a ship to the same destination to attain a better rate. Cargos are bought based on a CIF or FOB basis at the loading port. In both cases, risk and title of the oil passes from seller to buyer when the crude oil is loaded onto the ship. The CIF terms include the freight and insurance provided by the seller and included in the price, while the FOB terms only include the cost of the oil. The shipping company charges market-related rates to the Trading Company or Operational Company depending on which Company is carrying the transport fees. Shipping rates are based on the internationally published rates for the petroleum industry.

In terms of the direct or on-charged transport costs, the following should probably be investigated by the tax authorities:

The transport rates for moving crude and refining products by ship is published on a monthly basis. These rates should be compared to the transport costs carried ultimately by the Operational Company to ensure that the rate charged is comparable and arm's length.

*Refinery and manufacturing*

Manufacturing by local operating companies focuses on refinery and chemical plant operations making products such as gasoline, diesel, heating oil, aviation fuel, lubricants and bitumen. Crude purchases are usually paid within 30 days to the Trading Company. The refining of crude and manufacturing of lubricants is managed by the local operational company in conjunction with the regional holding company.

*Purchases of finished product*

Local operational companies that do not have refineries are not able to produce a specific petroleum product or lubricant and make purchases from Trading Company 2 situated in Country C (a low-tax jurisdiction). Trading Company 2 will then source the relevant product on request from the operating company, either from the operational Companies

situated in other countries or in certain instances from other petroleum companies. Depending on the product, origin and volume, the Group's shipping company may be used. Trading Company 2 would buy the relevant product and on-sell the product to the local company. The trading company adds a premium to the sales price, which fluctuates depending on the volume and type of product sold.

The premium charged by Trading Company 2 erodes the tax base of the operational resident country. In terms of the premium charged by Trading Company 2, the following should probably be investigated by the tax authority:

The premium is based on the overall market price and then on-charged per barrel or litre purchased by the Operational Companies. The calculation via units purchased has the effect that a substantial profit is made by the Trading Company. The premium price should be compared to the relevant daily market-related data of petroleum products.

### *Distribution*

The operational companies own the refinery and lubricants factory and have a substantive network of storage tanks and distribution facilities. The product is sold directly to wholesalers or other oil companies depending on surpluses or country-by-country agreements. Depending on local legislation, the Operational Company may own several service stations to which the refined product is directly delivered via their own fleet or independent contractors.

### *Distribution of surplus product*

Previously, the Operational Company's internal marketing department made sales of surplus petroleum products to non-resident unrelated companies. This function has now been centralized through Trading Company 2 located in Country C (a low-tax jurisdiction). Operational Company informs Trading Company 2 of any surpluses after which the Trading Company secures buyers on a CIF basis. Trading Company 2 will then buy the surplus product and on-sell the product to independent third parties. Operational Company remains responsible for all relevant logistics and deliveries to the port and carries all risk up to the loading of the product to the arranged transport of the buyer.



The Trading Company usually takes flash title of the product just before delivery when ownership passes to the buyer. The Trading Company carries the risk of bad debts. However, no bad debts have occurred in the last few years due to the extensive guarantees and securities before delivery. Operational Company charges a five per cent commission on all purchases, which is relatively low, but is a substantial amount in relation to the volumes and ultimate price in a low-gross-profit industry.

The commission charged by the Trading Company erodes the tax base of the operational resident country. In terms of the commission charged by the Trading Company, the tax authorities should probably investigate the following:

Do the functions performed, the risks assumed and the assets used by the Trading Company warrant a commission of five per cent?

The interposing of the Trading Company has synergy benefits in terms of the overall group perspective. However, the following possibilities should be looked at to help determine if the amount paid can be considered to be at arm's length:

- The Trading Company carries minimal risk for the product as they only receive a flash title. Its exposure to non-payment appears minimal.
- The Trading Company does perform functions regarding securing buyers. These appear to have been built up by the operational companies themselves. The Trading Company has minimal assets in Country C, which consists of a few trading desks and a manager.

In these circumstances a cost plus-basis charge by the Trading Company to the operational companies might be more representative of an arm's length price for services rendered to the operational companies than the five per cent commission.

### *Cost contribution arrangements (CCAs)*

A global and regional cost sharing arrangement exists between the operational companies. The cost sharing arrangement allows for the equal sharing of risk, knowledge and expertise. Costs are allocated between the respective operational companies based on allocation

keys, which range from full-time employees, computer devices to sales. Each operational company will share costs in the global pool, but costs would only be shared for the specific region in the case of regional pools. The operational companies in the group obtain services through the cost sharing agreement in the following areas:

- Human resources;
- Finance;
- Legal;
- Information technology; and
- Communications.

Pursuant to the cost sharing arrangement, all costs for the year are invoiced to the operational companies as per the allocation keys. The CCA is tax resident in Country E (a low-tax jurisdiction) but operates on a non-profit basis. The allocation keys and apportionment of the costs are audited on a yearly basis by a large accounting firm. Due to the high auditing costs, the accounting firm is requested to only provide an overview of the costs, and to issue a certificate to this effect to each operational company in the CCA together with an invoice for the yearly costs.

Considering the above facts related to the allocated CCA costs, the tax authority should probably investigate the operational company claiming the costs relating to the invoice from the CCA and check:

- (i) The actual benefit received and conduct a benefit analysis of the services received;
- (ii) The applicability of the allocation keys used; and
- (iii) The reasonableness of the portion of costs carried by the operational company.

Should these investigations indicate that the benefit does not support the cost allocated, the expense should not or only be partly allowed as a deduction against taxable income.

### ***Example 3: Market volatility issues***

#### *Facts*

Oil and Gas (O&G) Company decides to lease drilling equipment from a related party for several years at a time when drilling equipment is

scarcely available due to a high-demand market caused by high oil prices. The drilling equipment is to be used globally to realize activities in diverse countries where Exploration & Processing (E&P) campaigns are (expected) to be performed during these years of high oil prices.

In 2014 the oil prices drop significantly. A consequence of this unexpected drop in price is that drilling equipment becomes available in the market at very competitive fees, and considering the impact on profitability of high cost and reduced earnings, several planned E&P projects are cancelled by the O&G Company.

### *Findings*

The O&G Company that entered into the drilling equipment lease continues to pay a recurrent fee to the owner of the drilling equipment that was previously hired, even if the drilling equipment is on standby and not currently in use.

At issue is whether the price paid for the drilling equipment between related parties—consistent with the intercompany agreement which is not adjusted for current market prices—qualifies as being at arm's length.

### *Considerations*

The price paid is a consequence of the contract entered into between parties and the fact that it is difficult to quantify the cost of the risk of not having the equipment available at the time a drilling campaign approaches its spud date in a certain country against the cost of the risk of oil prices dropping.

The related party which invested in the long-term lease arrangement in the drilling equipment still requests the agreed price, whereas the related operating company is currently not able to use the drilling equipment and may request for price adjustments.

To determine if the pricing applied is at arm's length, it is valid to consider all available information. Well-prepared transfer pricing documentation that memorializes relevant economic conditions and other relevant facts contemporaneously may offer support and evidence of the business decision that will help clarify if the pricing is arm's length and may help allow the deductibility of costs from

related entities in those cases or, if the case may be, the deductibility of non-recharged costs at the related entity level when such cost were unable to be invoiced to related parties due to inexistence of the service.

***Example 4: Financing costs***

*Facts*

O&G Parent Company is based in Country A. O&G Operating Company develops a block in developing Country B. The condition of the concession to conduct E&P activities limits the amount of interest expense that may be deducted from the taxable tax base.

In the exploration phase it is usually not feasible to obtain loan financing given the exploration activities are capital intensive and high risk. Once the project moved from the exploration stage into the development stage, O&G Parent Company switched to project finance (loans). Therefore, Parent Company issues an intercompany loan.

Because of the concession conditions, developing Country B disallows a portion of the interest costs incurred by oil and gas Operating Company while Country A includes the full interest in the tax base of oil and gas Parent Company resulting in double taxation.

*Considerations*

In essence, this is not a transfer pricing issue, but more a conflict between the concession agreement and the tax legislation of the Parent Company. Transfer pricing considerations would relate to determination of an arm's-length interest rate or requalification of the loan into equity.

***Example 5: Horizontal ring-fencing***

*Facts*

MNE Group D Company consists of three taxpayer entities: Principal Company, Company A and Company B. Company A and Company B are each special purpose vehicles whose sole business consists of the exploration and, if successful, development and operation of Blocks

A and B respectively. Principal Company acts as group coordinator in Country M. In this role, Principal Company contracts with an arm's-length service provider to undertake exploratory drilling in blocks A and B. The fee for this service is 100 per block.

Assume that in the area of Blocks A and B and given the stage of exploration, it is anticipated that 50 per cent of exploratory drilling will be successful such that it will lead to development of the block and production of oil.

Company A and Company B each initially pay a fee of 50 to Principal Company for the drilling work undertaken by the service provider. A further 150 is payable to Principal Company if the drilling is successful.

### *Findings*

In this case example, it turns out that Block A is successful and Block B is not. Furthermore, the oil produced by Block A results in 1,000 of income. Company A's accounts will show an initial loss of 200 (the 50 initial fee and the 150 success fee) but this loss can be offset against its future income of 1,000. Company A's net taxable income is therefore 800. Company B's accounts will show a loss of 50 (the initial fee). As Company B has no income and the ring-fence does not allow Company B's loss to be transferred elsewhere, the 50 of costs are effectively stranded costs and can never be deducted against income. Principal Company's accounts will show total income of 250, consisting of 50 from Company B and 50 plus 150 from Company A. Principal Company's costs of 200 (100 x 2) are paid to the service provider. Principal Company's net income therefore is 50. The total Group taxable income in Country M is  $800 + 50 = 850$ .

### *Considerations*

These arrangements may lead to shifting of costs between ring-fenced blocks and effectively overriding the ring-fencing. If Company B makes a successful discovery and receives its success fee, that fee constitutes costs of the successful block, which may be used to offset against future taxable income from that Block. Company B is facilitating the override of the ring-fencing for Company A. It would be relevant to look for unrelated comparables.

Without the interposition of Principal Company between Company A and Company B, and without making use of the success fee that Principal Company demands, the accounts would show a different picture. Company A's accounts would show a tax loss of 100 (the service fee paid for exploratory drilling) which can be offset against its income of 1000. Company A's net income would be 900. Company B's accounts would also show a tax loss of 100 (the service fee paid for exploratory drilling) but this amount would constitute stranded costs. The total group taxable income in Country M would therefore be 900.

One can question whether the pricing between Company A and Company B and Principal Company—and making use of a success fee—is at arm's length, and it should be determined what an arm's length fee would be for the services rendered by Principal Company.

### ***Example 6: Cost sharing arrangement***

#### *Facts*

O&G Company has a cost sharing arrangement in which all the operating entities participate. Under the cost sharing arrangement, costs of rendering services as well as R&D development are shared among the participants on a projected benefit basis. The participating operating entities have access to all the developed technology and jointly own the intellectual property (IP).

The O&G Company is rolling out a multi-year project to deploy a new information technology (IT) system across the world. The cost of this project is included in the cost base of the cost sharing arrangement and is allocated based on PC count in the respective operating entities. In year one, the programme is rolled out in Countries A and B, but not yet in Countries C and D. Still the operating companies in Countries C and D need to bear their proportionately allocated costs under the cost sharing arrangement. In year two, the programme is rolled out also to Countries C and D.

#### *Findings*

In year one, Country C and Country D treat the cost sharing as a cafeteria-style arrangement, implying that the operating entities

should only share the costs in which it has a current-year benefit (cherry picking) and therefore not receive a proportionate charge of the new IT system costs.

Under the cost sharing arrangements, all participants are entitled to IP resulting from pooled R&D. Country C disallows the operating entity in its country a deduction for the proportionate charge of the R&D activities as they do not see current benefits.

### *Considerations*

Cost sharing arrangements generally consider anticipated benefits and not only current-year benefits (reference is made to the Manual, part B.6). A bona fide cost sharing arrangement requires consistent use of allocation keys among the participants. The applied allocation key should reflect a reasonable allocation of anticipated (future) benefits. Where countries would prefer cost sharing for services to cost sharing for R&D, it should be considered that the latter may reduce future royalty discussions for IP used by the cost sharing participants operating in their countries.

### ***Example 7: Intercompany charges at cost***

#### *Facts*

Under a production sharing agreement, a consortium of three independent parties is established. From among the participating companies, an operator is appointed. The operator runs the project on behalf of the consortium and provides all technical and functional services, ensuring that costs and risks are shared with the consortium members. Pursuant to the consortium agreement, the operator is not allowed to benefit or be disadvantaged by its position, compared to the non-operating consortium members. As such, the consortium agreement stipulates that the operator and its affiliates may not earn a profit from undertaking activities for the benefit of the consortium.

#### *Findings*

The tax authority of the country where the related service company of the operator is located requires a markup on the services provided to the consortium.

The operator takes the position that the consortium agreement does not allow his associated service provider to charge a markup on its services. In case a markup on costs was to be charged due to commercial and legal arrangements, the consequences would include cost rejections by partners to the production sharing agreement and joint operating agreement and double taxation.

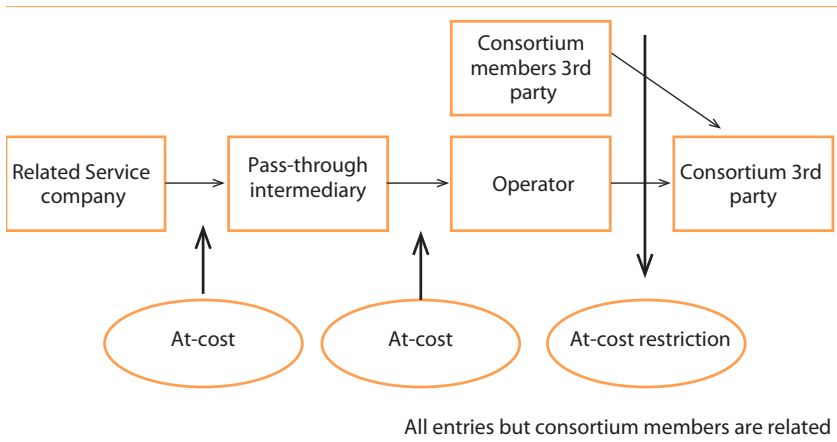
*Considerations*

The issue to be resolved is whether the consortium arrangement provides a comparable basis for asserting that charging at cost is appropriate.

Figure VI.5 below depicts how the at-cost restriction for services rendered by all consortium members is passed on to the operator or service company:

Figure V.5:

**Flow of at-cost restrictions**



Source: UN/DESA.

**Example 8: Performance guarantees and bonds**

*Facts*

Country A awards an oil and gas exploration and development licence to Operating Company X. Operating Company X is incorporated in developing Country A and is a subsidiary of Company Y. Company Y



is incorporated in Country B. Country A, as a condition for awarding the licence, requires two types of guarantees with respect to Company X's obligations. First, Country A insists that Parent Company Y guarantee in full the obligations Company X has agreed to under the licence contract throughout the contract life. Second, in addition to the parent company guarantee, Country A requires a more limited but third-party provided performance bond granted in favour of host Country A. Under this bank performance bond, an unrelated third party, Bank Z, guarantees 7.5 per cent of the total obligation value under the contract for the first four years of the agreement.<sup>201</sup>

### *Findings*

Country A's tax authorities review the performance guarantee provided by Parent Company X and find that no charge has been made to its subsidiary, Company Y. They further note that in the case of the performance bond provided by independent Bank Z, a fee has in fact been charged. After further researching the bank guarantee, it is

---

<sup>201</sup> See, for example, Article 29.1 of India Model Production Sharing Contract, as quoted in table 1 at A.4.: "Each of the Companies constituting the Contractor shall procure and deliver to the Government within thirty (30) days from the Effective Date of this Contract: (a) an irrevocable, unconditional bank guarantee from a reputed bank of good standing in India, acceptable to the Government, in favour of the Government, for the amount specified in Article 29.3 and valid for four (4) years, in a form provided at Appendix-G; (b) financial and performance guarantee in favour of the Government from a Parent Company acceptable to the Government, in the form and substance set out in Appendix-E1, or, where there is no such Parent Company, the financial and performance guarantee from the Company itself in the form and substance set out in Appendix-E2; (c) a legal opinion from its legal advisors, in a form satisfactory to the Government, to the effect that the aforesaid guarantees have been duly signed and delivered on behalf of the guarantors with due authority and is legally valid and enforceable and binding upon them (...)." Available at <http://www.dghindia.gov.in/assets/downloads/56ce986044a31ModelCBM.pdf>. Also, see *Sharing Contract between Nigerian National Petroleum Corporation and (i) Gas Transmission and Power Limited, (ii) Energy 905 Suntera Limited and (iii) Ideal Oil and Gas Limited, covering Block 905 Anambra Basin* (2007). Available at <http://www.sevenenergy.com/~media/Files/S/Seven-Energy/documents/opl-905-psc.pdf>.

determined that the capitalization of Company A is sufficient to satisfy the coverage requirements of the bank for its level of exposure, but if the exposures were materially higher, Bank Z would not issue the performance bond without additional capital or further protections.

### *Considerations*

The issue involved is whether Parent Company X should charge a fee for providing its performance guarantee for Company Y's obligations and, if so, how should the appropriate level of the fee be determined.

One approach to be explored is whether the third-party Bank Z's fee for its guarantee can be used as a comparable to determine what an arm's length fee for Company X's guarantee should be. In evaluating this, a key difference can be observed—i.e., that the level and time-frame for Bank Z's exposure is far different from that of Company X. This difference is clearly material, and the tax authorities will need to assess whether some type of “multiplier” to that fee can be made. They will also need to consider what additional protections a third-party bank would seek.

An additional consideration could be a finding that for related party contract guarantees (such as the parent company guarantee in the example) prevailing practice is that there is generally no charge to the in-country affiliate for a parent company guarantee.<sup>202</sup> The basis for not charging a fee in these circumstances is that the guarantee is often viewed as a requirement for the affiliate (and indirectly, the parent) to qualify for the contract, and is thus just as much a benefit to the parent as to the affiliate. Alternatively, the parent guarantee is often viewed as simply the equivalent of an agreement to further capitalize the subsidiary if needed to meet its obligations, and generally not something for which a fee is charged.<sup>203</sup>

---

<sup>202</sup> See Shepherd and Wedderburn LLP, *Parent company guarantees and performance bonds* (2010): which notes that “(...) a parent company guarantee should be provided at no cost to the developer, whereas there will be [a] charge for [third party] performance bonds....”. Available at <http://www.shepwedd.co.uk/knowledge/parent-company-guarantees-and-performance-bonds>.

<sup>203</sup> See the United Nations Manual on Transfer Pricing for Developing Countries and the OECD Transfer Pricing Guidelines regarding intra-group services and when a charge may be appropriate. The former provides:

---

“B.4.2.13. Shareholder activities are activities undertaken to provide an economic benefit only to the shareholder company (ultimate parent company or any other shareholder such as an intermediary holding company, depending on the facts of the case) in its capacity of shareholder. Accordingly, the cost of shareholder activities should be borne exclusively by the shareholder. Shareholder activities performed by an associated enterprise on behalf of its parent company should be charged to the parent company on an arm’s length basis.”

B.4.2.14. Shareholder activities may include the following:

- the activities of the parent company for raising funds used to acquire share capital in subsidiary companies; and
- the activities of the parent company to protect its capital investment in subsidiary companies.”



## Chapter 6

### THE TAX TREATMENT OF DECOMMISSIONING

#### Executive summary

This chapter covers the tax treatment of rehabilitation/decommissioning<sup>204</sup> costs for mining and oil and gas projects. Such decommissioning may be required under a wide range of domestic laws, international agreements and voluntary guidelines. Decommissioning requirements may be mandated by law or by the agreement under which the extraction activity has taken place, and may be intended to meet a number of goals.

In order to consider the tax treatment of decommissioning costs, it is necessary to understand the environment in which those costs will be accrued and incurred. This chapter therefore first addresses the broad principles behind a government's regime for decommissioning and considers the actual work that needs to be done to achieve local, national and international requirements. It then discusses methods by which responsibilities to carry out such work are assigned, and the different legal frameworks which govern the relationship between the host state/resource owner and the contractor involved with the extractive activity.

Building on this legal and commercial background, the chapter then examines different models for funding decommissioning work, and the methods by which costs can be estimated. It examines three key models and the direct tax treatment of each such model. The models represent choices that can be made by a country in designing its tax regime for the extractive sector, and each model could potentially distort the decisions made in relation to decommissioning. These potential distortions are identified and methods to address adverse distortions under each model are discussed.

#### Introduction

The two main extractive industries are mining and oil and gas; within each of these categories, there is a range of technology requirements

---

<sup>204</sup> Hereafter referred to as “decommissioning costs” for ease of reference.

depending on the resource to be extracted, its location (e.g. onshore or offshore) and the facilities needed to process the extracted resource. Such facilities may require large multi-year capital investments in infrastructure or access to additional inputs for processing the output of natural resource projects. As the mines and the oil and gas facilities become depleted, they require decommissioning and remediation.

Decommissioning is a complex multi-disciplined process with an overall timescale normally lasting several years, requiring the management of diverse issues and involving international and government agencies, mining or oil and gas producing companies, third party contractors, local communities, and non-governmental organizations.

There are many thousands of mines and oil and gas fields in operation worldwide which will need to be decommissioned, including 8,000 offshore oil and gas installations. Oil and Gas UK has indicated the decommissioning cost on the United Kingdom continental shelf at about £59.7 billion.<sup>205</sup> The very high costs to decommission such facilities will reduce the net profits of the private sector. Governments will correspondingly collect less income and/or profit taxes as a result of decommissioning obligations.

Decommissioning is part of the life cycle of an installation. Within that life cycle, the financial and technical planning of decommissioning and remediation phases often receive insufficient consideration during the planning, design and operation phase of these facilities. This has led to many unforeseen issues and challenges, as mines and oil and gas facilities reach the end of their economic life.

There is also a legacy of mines and oil and gas fields that have already been closed and decommissioned in the last century and which today are creating environmental and risk issues, as there are no clearly responsible parties and/or no funds reserved to address the decommissioning and closure issues. Furthermore, these issues can foster a negative opinion and reputation of the industry and cause communities to oppose plans for new extractive industry operations.

---

<sup>205</sup>The UKCS Decommissioning 2017 Cost Estimate Report, available at <https://www.ogauthority.co.uk/news-publications/publications/2017/ukcs-decommissioning-2017-cost-estimate-report/>.

The closure phase must comply with sector law and regulations and/or the closure, decommissioning and remediation terms in the lease. Typical steps to comply with these requirements are:

- Clarification of the sector and national law, regulation and guidelines applicable to the closure of the mine;
- The removal or conversion of infrastructure and rehabilitation of land;
- In the case of mining, the stabilization of open pit or underground workings (foundations, mine shafts, buried pipelines, etc.);
- Removal and/or rehabilitation of tailings, rock stock piles, etc. from the mines, and drill cuttings, shell mounds, wells etc. from the oil and gas operations;
- Management of surface and groundwater and air quality;
- Post-closure monitoring to ensure that potential environmental issues are effectively managed;
- Transfer of liability, for example on reversion of ownership to the state; and
- Recognition of residual liabilities.

### **Key drivers in determining decommissioning principles**

The key drivers which affect the decommissioning of mines and oil and gas facilities are:

1. Politics, public concern and reputation;
2. National and international legal requirements;
3. Contractual obligations assumed by the investor/licence holder;
4. Cost and economics;
5. Taxation framework;
6. Technical feasibility;
7. Health, risk, safety and security;
8. Environmental impact; and
9. Other users of the land and the sea.

The above listed elements are not ranked in order of importance, and policymakers should decide the weight to be given to each element based on the economic conditions and policy priorities of their own country for an overall decommissioning regime. Further, within that national approach, it is recommended that the ranking of each facility in the country against these criteria should be carried out on a case-by-case basis.

The political and community impacts of the closure of major facilities in a community make decommissioning more difficult. There are often profound economic consequences on local communities or host nations in association with mine shutdown and the decommissioning of oil and gas facilities. Environment, sustainability, health and security (ESHS) issues may be especially complex in the social context and provisions may have to be made for retraining workforce, development of sustainable economic alternatives to mining and oil and gas activities, or the management of reduced-scale and downsized facilities. This also triggers intense and detailed scrutiny of the decommissioning and closure process by the affected communities and the local and national government.

Mining operations tend to impact significant areas of land and hence the decommissioning work needed can be extensive, particularly in open pit mines.<sup>206</sup> For example, once mining finishes, the following activities might be undertaken:

- Waste dumps flattened to further stabilize them against erosion;
- The mine covered with a layer of clay to prevent access of rain and oxygen from the air, which can oxidize the sulphides to produce sulphuric acid;
- Landfills covered with topsoil, and vegetation planted;
- Dumps fenced off to prevent livestock denuding them of vegetation;
- The open pit surrounded with a fence, to prevent access, and filled up with groundwater; and

---

<sup>206</sup> For underground mines, decommissioning work may be significantly less due to lower volumes of waste rock and tailings. Furthermore, the removal of plant and infrastructure is not always part of a rehabilitation programme, as many old mine plants have cultural heritage and value.



- Tailings dams left to evaporate, then covered with waste rock, clay and soil, to stabilize them.

The nature of the above activities can, depending on the nature of the mine, require that these activities be undertaken at the end of the useful life of the mine, rather than in stages as the mine is depleting.

Oil and gas operations tend to have less impact on areas of land and offshore zones than mining, but nevertheless proper assessment and decommissioning needs to be executed.

The nature of traditional onshore and offshore upstream exploration and production (“E&P”) i.e. oil and gas operations, results in a smaller footprint than that of most mining operations. Hence, the scale of land rehabilitation, re-vegetation and other reclamation activities associated with mining does not typically apply to upstream hydrocarbon operations. Furthermore, part of the decommissioning can be undertaken in stages, rather than waiting for the end of life of the field. Notwithstanding these generalisations, it should be noted that some unconventional oil and gas projects have characteristics which bear closer resemblance to mining projects in terms of their economic profile and, in some cases, arguably, the environmental footprint (e.g. oil sands).

Closure phases of mines and oil and gas fields comprise numerous complex and costly activities such as:

- Clarification of the sector and national law, regulation and guidelines applicable to the decommissioning and remediation of oil and gas facilities (onshore or offshore);
- Interpretation of law and regulations to produce environmental, safety and technical “Rules for Decommissioning”;
- Development of the case-specific decommissioning and remediation option, evaluation and selection process;
- Execution of a public and government review of the decommissioning option selection process and outcomes, where not already provided for under statute;
- Preparation of decommissioning engineering, permitting, project execution and dismantling, and removal of structures used during resource exploitation;

- Implementation of remedial measures to manage ESHS issues remaining from operations or resulting from cessation of operations and decommissioning activities;
- Restoration of the site to an agreed-upon use and quality in line with the expectations of government authorities, relevant stakeholders, and nearby communities;
- Final survey and verification;
- Achieving project signoff by government; and
- Assessment of any future liability.

As many of the existing mines are nearing depletion or the economic limits of extractability and oil and gas fields are in decline, closure, decommissioning and rehabilitation activities are expected to increase. This closure process will result in a complex sustainability issue which is part of the natural life cycle of a mine or an oil and gas field.

Planning for the closure process should begin during the early phases of the project life cycle, incorporating environmental concerns as well as health and safety issues and the socioeconomic needs of the nearby population. Starting the planning requires clarity over who will be responsible for what. In the best cases, there are laws, regulations and contracts available that clarify this; however, this is not always the case. Engaging bilaterally to agree on these issues as early on as possible will help improve clarity and support a clear environment for investment decisions.

### **Approach to a tax policy framework for decommissioning**

This chapter recommends that policy makers utilize the following approach in determining decommissioning policy:

1. Establish principles of decommissioning from a governmental perspective;
2. Design the regimes for delivering decommissioning principles;
3. Understand and manage the risks from the interaction between the tax regime and decommissioning; and
4. Consider the recommendations made in this chapter on mechanisms to resolve tax issues.

## **Contract structures and fiscal regime design**

There are many different legal frameworks which govern the relationship between the host state/resource owner and the contractor tasked with developing the natural resource. These include concession agreements/licensing regimes, production sharing contract (PSC) type regimes and service contracts.

Conceptually these frameworks can each offer a variety of different fiscal ‘levers’ which can operate to share the risks and rewards of projects between the parties. These levers include, but are by no means limited to:

- Buy-in/auction payments;
- Production bonuses;
- Royalties;
- Profit based taxes; and
- Profit sharing with cost recovery mechanisms.

In this chapter, references to ‘tax’ and ‘taxation’ should be taken as references to all forms of payments received by the host state/owner of the resource in return for the development of its natural resources, including production sharing, and references to the “fiscal regime” are to the legal and economic framework which determines the taxes due. However, since taxes under non-income-based mechanisms do not commonly respond to costs, this chapter necessarily focusses on the way decommissioning expenditure is reflected (i.e., deducted) in the calculation of profit-based taxes/profit sharing and cost recovery calculations.

## **The broad decommissioning regime**

This chapter sets out the principles behind a government’s regime for the funding of decommissioning into which the taxation rules will need to fit. These are included since the taxation rules that are best for adoption will depend critically on the mechanism by which governments choose to fund decommissioning.

## **Decommissioning principles**

The following guiding principles are used within this chapter when considering the precise design of the tax regime—i.e., that the tax regime should not undermine any of the principles below.

1. Governments should recognize the decommissioning liabilities of a resource project, which should be explicit and visible at the start of project life cycle, and should be updated during the project life. These include both discrete liabilities and residual liabilities.

The reason why this is important is that the costs (and risks of uncertainty) relating to the decommissioning liability will be factored into the decision-making of the private sector entity and hence the government will have lost value unnecessarily if the liabilities it ultimately imposes are significantly less than the prudent assumptions of the investor.

2. Where liability lies should be the choice of the government of the resource state—government should not unwittingly be left with the liability to perform decommissioning. Roles and responsibilities for decommissioning should be clearly defined at the inception phase of extractive projects. These should include:
  - a. Responsibility for execution;
  - b. Responsibility for costs;
  - c. Stewardship of decommissioning; and
  - d. Rules for transfer of liabilities on transfer of ownership of projects or assets.

This will allow all parties to understand their roles and to plan accordingly.

3. Rules should have enough flexibility to enable a range of technology choices and be responsive to project needs, recognising that technology choices can change over time. The overall decommissioning regime should not constrain the opportunity to take advantage of improvements in technology. Rules that lock participants into technologies early are likely to result in a sub-optimal choice of decommissioning outcomes once the decommissioning starts.
4. Governments should develop decommissioning policy bearing in mind national socio-economic, environmental, finance and governance impacts. Management of the

regime should encourage a “whole of government approach” (which should include the national oil company where present)—the agreement of regulators on the policy approach is essential for efficient oversight and management of the decommissioning process. Government and national oil and gas companies should also have a clear strategy for managing conflicts in priorities (e.g. between costs of full removal versus alternative solutions).

The choices on decommissioning will have a wide range of impacts so it is important that the decisions are coordinated across the relevant government departments.

As an associated point, developing countries, regional and international organisations should strive to build capacity on decommissioning matters and share knowledge among countries.

### **Choosing who is responsible and who should pay**

There are two key decisions that are needed in determining the decommissioning regime and these will critically impact the tax rules applicable to decommissioning expenses. These are:

- Who has responsibility for decommissioning, such as:
  1. The government;
  2. The licence holder; or
  3. Shared between the licence holder and the government.
- Who pays for the decommissioning, such as:
  1. The government pays for it all;
  2. The licence holder pays an agreed amount;
  3. The licence holder pays an agreed fraction; and
  4. The licence holder pays for it all.

Typically, the licence holder or holders will pay for the decommissioning. However, a secondary effect can arise in two circumstances. First, where the profits from the licence activities are subject to a profit-based tax, the costs of decommissioning, as expenses of the business, will reduce the overall taxable profit, and taxes paid, as compared to a case where such costs are not required to be incurred.

Second, in the case of a PSC, if decommissioning costs are recoverable costs under the PSC, in the form of “cost oil”, for example, then the licence holder will be reimbursed for such costs.

### **Funding decommissioning**

The next question arising is how the decommissioning is going to be funded. For a company’s share, in essence, there are three key options:

1. Without any security;
2. With security, in the form of:
  - Assets pledged (including cash);
  - A parent company guarantee; or
  - A letter of credit from a bank.
3. With contribution into a fund:
  - Owned by the government:
    - Funds earmarked for decommissioning activity (i.e. ring-fenced from the general budget); or
    - Funds not earmarked (become part of the general budget).
  - Independent fund per project; or
  - Independent fund per company:
    - Held outside the company (e.g. in escrow);
    - Within the company (not ring-fenced).

These options can combine with the options set out in this chapter to create a complex environment, such that the options chosen by two countries can differ significantly. They raise a number of operational challenges. In relation to funds, the following questions arise:

- How much should be contributed into the fund?
- What is the mechanism for withdrawals from the fund?
- On what basis should the obligation to fund be imposed?
- When should companies pay into the fund?
- What companies should pay into the fund (is this just the licence holder?)

- What can be contributed into the fund (e.g. profit oil rather than just cash)?
- What happens in the event of a:
  1. Funding shortfall; or
  2. Funding surplus; and
- What currency is the fund?

Similar questions arise in relation to accounting and tax provisions.

Given the above, the fiscal regime will need to consider:

- Whether contributions to the fund are tax deductible when made, or at some other time (e.g., when the fund spends the moneys);
- Whether tax is imposed on drawings from the fund and/or any return of surplus and release; and
- How earnings on the fund itself are taxed (or exempt from tax).

These and other tax issues are discussed in the next section.

The government will also need to consider how it would fund its share of those liabilities which could arise through state participation in decommissioning. In addition, and as noted earlier, even without direct participation, income-based taxes to the government will be reduced given higher costs, and lower or no production, during periods of decommissioning. In many cases, losses will be incurred during such periods, and thus refunds of prior taxes paid may be due, triggered by the carrying back of losses from the decommissioning. Broadly, this may be met out of current period tax receipts or reserves which the government may hypothecate or commit into a specially designed fund.

### **Basic tax choices: an overview of the common models**

The basic choices for providing a tax deduction for decommissioning costs are as follows:

- Provide a tax deduction when cash is expended on decommissioning;
- Provide a tax deduction when decommissioning is accrued; or
- Provide a tax deduction when decommissioning is pre-funded.

These options are considered in more detail below. They are all seen in practice, as shown by the examples in the chart below. Sometimes the choice of Model 1 or 3 may be at the option of the taxpayer, as seen below.

Table VI.1:

**Examples of countries adopting models 1 to 3**

| Tax treatment/<br>model | Deduction<br>upon:      | Example countries                                                                                                                                  |
|-------------------------|-------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------|
| 1                       | Expenditure             | <i>Oil and gas:</i> Australia, Denmark, Norway, the United Kingdom and Zambia.<br><i>Mining:</i> Australia, Canada, Chile, Peru, South Africa, USA |
| 2                       | Accrual                 | <i>Oil and gas:</i> Netherlands.<br><i>Mining:</i> United States (by election)                                                                     |
| 3                       | Contribution<br>to fund | <i>Oil and gas:</i> Ghana, India and Mozambique, South Africa and Zambia.<br><i>Mining:</i> Canada.                                                |

Additional tax questions arise in relation to payments for security (e.g. letters of credit) such as how/when to:

- Provide a tax deduction for costs of obtaining security; or
- Provide a tax deduction if security is used (requiring the security issuer to obtain reimbursement from the taxpayer).

Again, the answers to these questions are likely to vary depending on the type of security.

In addition to the questions of the timing of deductions for decommissioning costs, there is also the valuation of the costs of decommissioning. The relevance of this will again depend on the model used, since estimates of costs will of course be harder to establish than costs that have actually been incurred.

In considering any of the options, the following assumption has been made: that if the tax treatment is understood by all parties upon entering into the licence/contractual agreement, then the overall “government tax take” (i.e. the overall amount of tax and other amounts payable to the state) will adjust to offset differences in tax treatment. **Hence the key**



**concern should be to ensure that any regime that is chosen does not create incentives that run counter to the decommissioning principles.**

Choices that merely change the timing of tax deductibility for decommissioning costs do not need to affect the overall amount of government take. On the contrary, as noted above, a well-designed fiscal and decommissioning regime should optimise the level of government take in the context of the appropriate sharing of risks for the exploration and development (including decommissioning) of a particular resource between the state and a company.

### *Model 1—Providing a tax deduction upon expenditure*

Under this system, a tax deduction is only provided on a cash basis, leaving no tax incentive for the taxpayer to pre-fund its decommissioning. This means that there will be a greater need for government to ensure that funds are available at the time of decommissioning. This therefore encourages the use of security.

This is the simplest mechanism as the expenditure incurred on decommissioning can be verified against an agreed decommissioning plan. There will be other questions that need to be addressed, such as whether costs are general expenditure rather than decommissioning costs and to which project the particular element of decommissioning expenditure relates (which is particularly important if the projects are taxed at different tax rates).

This also provides a cash flow advantage to the government since it will receive all taxes/receipts from the extraction of the resources but will only permit tax deductibility for costs at (or near) the end of life of the project.<sup>207</sup>

The choice of timing can also be linked to the choice of tax regime more generally—if the rest of the regime is effectively a cash flow tax (e.g. providing immediate relief for capital expenditure) then allowing relief only on a cash flow basis is consistent.

From a tax perspective, this means that the project will be paying tax once the project has repaid investment and will carry on doing so through to the end of project life. At that point (or slightly beforehand)

---

<sup>207</sup> Of course, the cash flow impact on the taxpayer will be the opposite.

the taxpayer will incur decommissioning costs which will crystallise a large loss once the project has entered the decommissioning phase.

In most tax systems, tax losses are carried forward to the next tax year and allowed as a deduction in that year. However, the use of a loss carry-back will be needed as a way to provide an effective tax deduction for such costs unless there are other ways to offset the loss. A special provision can be made in the corporate income tax law to allow loss carry-backs in the case of a terminal loss arising from the closure of mining or oil and gas operations. In turn, this may involve reviewing the income taxes paid for previous years and will typically result in refunds of taxes paid for such years.

Policymakers will need to be conscious of the government budgetary implications and availability of funds for refunds. Further, consideration will need to be given to the administration of the carry-back.

Assuming the budgetary and administrative issues can be resolved, the use of loss carry-backs can be an effective means of providing a tax deduction for such costs. This is particularly true when ring-fencing applies; also, it allows for accurate deduction of the actual costs incurred, and avoids the issues of recapture of excess deductions taken or allowance of further costs inherent in other mechanisms.

Rules are needed to cover how that loss is deducted, such as allowing offset against profits made earlier in the project life. If this is achieved through a carry-back of the loss against the most recent periods first (i.e. on a last-in-first-out or “LIFO” basis) then the effective tax rate will be the rate that applied near the end of the project life rather than at the start of project life. Where the tax rate has varied in line with the profitability of the project, this may be considerably less than the peak tax rate on the project or indeed the average rate. Significant uncertainty may arise due to the risk of law changes and this is exacerbated by the long period before effective tax deductibility is obtained.

### ***Model 2—providing a tax deduction upon accrual***

Under this model, a tax deduction is taken as the decommissioning expense is charged to the profit and loss account. Where the expenditure has not yet been incurred, this will create a provision for

future expenditure. The taxpayer will get the tax deduction earlier in the life of the project than under Model 1.

The provision method enables the taxpayer to most efficiently deploy its capital. It may be argued that, without the obligation of an actual cash outlay, tax-deductible provisioning can increase the expected rate of return from the project since it provides improved cash flows over Models 1 and 3. It thus could also result in greater returns to the state given the different discount rates used.

On the other hand, policymakers should be conscious that an unfunded provision requires appropriate and robust controls and monitoring processes to ensure that excessive amounts are not being provided for.<sup>208</sup> Further, it may be prudent to ensure that, while a provision is being made, there is some corporate backing provided by the operator, in the form of one or more financial guarantees (discussed at section above) that the operator will perform its decommissioning obligations.

Finally, it will also be necessary to develop rules to deal with excess or inadequate provisions made. Where excess sums have been provided for, there should be explicit provision in the tax law to recapture the excess. A further consideration here is whether the recapture should be at the tax rate of the excess provision year(s) or the year in which recapture takes place, and whether interest should be charged. Again, policymakers will have to consider the trade-offs in view of their need to attract additional investment to the extractive sector, their revenue goals and need to have a simple and clear decommissioning regime.

This model has the following characteristics which need particular attention:

- Estimate of costs: The estimate will be based on the decommissioning plan or equivalent documentation, where the associated costs will have to be estimated and agreed with the relevant sector ministry in advance.
- Accruing the costs: It will be necessary to have detailed rules on how the provision should be calculated and how much is

---

<sup>208</sup> The use of the accounting provision for decommissioning costs can operate as a constraint on over-accruals.

allowed to be provided for each year. The operator may also be given a choice of different methods of accruing the provision, e.g. provide for the estimated cost over the life of the field, or based on each unit of production (i.e. a certain fixed amount is provided for against each ton of ore or barrel of oil produced). The government could also determine a specific provision schedule as part of the negotiations with the operator in relation to the concession.

It will also be necessary to take into account the tax treatment of foreign exchange gains and losses relevant to the accumulated provision. Typically, the deductions will be allowed in the currency in which the operator submits the accounts, which in most cases will be in the national currency. However, the actual decommissioning costs will typically have to be paid in other currencies, and the conversion rate of such costs to the national currency may be different than when such costs were accrued. Therefore, in making interim or final adjustments to the provision, it will be necessary to consider currency movements. If amounts are accrued and deducted based on local currency, devaluation of the currency will mean that additional contribution will need to be made to the accumulated provision. Hence a current year deduction could consist of the accrual for that year plus an additional accrual for prior year amounts that have appreciated or depreciated in value.

### ***Model 3—providing A tax deduction upon pre-funding***

Some governments require or allow companies to contribute to a decommissioning fund out of which the decommissioning liability is settled.

This model provides a tax deduction for contributions made to a dedicated and protected decommissioning fund. Typically, contributions would be made by a licensee who is liable for a share of decommissioning costs under a joint operating agreement. Decommissioning expenditure met directly or indirectly by the fund would not receive further tax deductibility. The fund would be outside of the sole control of the company or the government and, once committed, funds could only be released to pay for decommissioning expenditure.

The fund would be “insolvency remote”, such that it could not be accessed by, for example, a liquidator should a licensee be put into liquidation. Once contributed, funds could only be used for legitimate decommissioning expenditure (whether before or after cessation of production) or refunded if the fund was in surplus once all decommissioning has been carried out.

Under this approach the taxpayer obtains a tax deduction for the costs before cessation of production and there is a shorter period during which the taxpayer is exposed to the risk of law change.

The use of decommissioning funds raises the following questions:

- Timing of deduction: The timing of a tax deduction will have cash flow implications for the government. The options include providing relief:
- Upon contribution of the cash to the fund: Tax deductibility can take place on an “as-funded” basis—i.e. when an actual payment is made into a decommissioning fund or trust fund established for this purpose. This is established practice in a few countries, including India, Mozambique, Zambia and South Africa. Examples of the rules applicable in the last two countries are provided in Annexes A and B to this Chapter.

These contributions are made during the development and/or operations phases of the project. It is important to clarify when to start the contributions to the fund. The fund (or other holding mechanism) is then used for project decommissioning costs at the end of useful life. Under this approach, the deduction is allowed well in advance of the date that the decommissioning expenditure is actually incurred, but at the time the operator makes a cash payment to the fund and loses control of that cash. The project operator’s deduction occurs when it is earning income from mining or oil and gas operations against which the deduction can be offset. The financial and tax treatment, and therefore budgetary impact for the government, is settled at the time of contribution to the fund—rather than the

implications only becoming apparent later, when the provision is used for decommissioning.

The ability to take the tax deduction upon contribution mitigates the timing disadvantage to the operator of contributing to the fund, but is less attractive to the operator as compared with Models 1 and 2. It does provide greater visibility and assurance to the government concerned that funds will be available at the end of project life than Model 1 or 2, unless some additional security is provided under those Models.

- Upon accrual of the expenditure by the fund: For funds that remain close to the control of the taxpayer, deduction may only be given once it is clear that the funds will be spent on tax-deductible decommissioning activity. Hence, deductions could be delayed until the fund contracts for such activity. Given the difficulties in verifying the contractual relationships, this option should be used with caution.
- Upon expenditure by the fund: This provides the same tax effect as Model 1 above, but has a far more onerous commercial implication since the operator is required to provide the funds early but is entitled to the tax deduction only at the later date of actual expenditure on decommissioning costs.

Note that the independent fund per company model could in some cases give the company the possibility to deduct a surplus from other fields or activities. This will depend on the specific agreement/legal framework.

- Treatment of surplus: The treatment of the surplus will determine the attractiveness to the taxpayer of contributing to a fund. In almost all cases, if contributions are tax deductible on the way in then, to the extent the surplus is repaid to the company, it should be taxable at that time of repayment.
- Taxation of deficit funding: The tax system can be used to provide an incentive for the taxpayer to finance the decommissioning fund, for example, by allowing a lower rate of deduction on any contributions that are made towards the end of project life. However, this will complicate the tax system and, hence, may not be the most efficient way in which to provide the incentive.

- Taxation within the fund: The taxation of the fund (i.e. whether the income of the fund can roll up free of tax, or exemption from any wealth/capital taxes) will materially affect the quantum of the funds available for decommissioning. However, this can be considered in determining the levels of contribution required.

Table VI.2:

**Types of decommissioning fund and tax Treatment**

|                                | <b>At contribution</b>                                                                                                                     | <b>Upon amortisation</b>                                                                                        | <b>When spent</b> |
|--------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|-------------------|
| <b>Government</b>              | Deduction can be justified at this time, since the funds are out of the control of the tax payer.                                          | N/A                                                                                                             | N/A               |
| <b>Independent per field</b>   | Deduction can be justified at this time, since the funds are out of the control of the tax payer.                                          | N/A                                                                                                             | N/A               |
| <b>Independent per company</b> | Since the fund relates only to one company and it might receive a refund of any surplus, caution should be taken in relation to deduction. | Once the fund has contracted for the decommissioning, deduction could be provided to the taxpayer.              | N/A               |
| <b>Company</b>                 | This is equivalent to an accrual. No deduction since there has been no setting aside of funds.                                             | Deduction should be given on the same basis as if there was no fund. May be a stronger case for accrual relief. |                   |

**General questions: measuring the costs of decommissioning**

A fundamental question in relation to providing deductions for decommissioning costs is what costs are properly considered to be decommissioning costs. This involves both the determination of what qualifies as such, and also the mechanism for estimating the costs that will be incurred in the future.

*Measuring the costs of decommissioning*

Specific decommissioning plans are generally set out in regulations that have their basis in national legislation. The determination as to which of the associated costs should be included in the decommissioning cost estimate should be governed by the legal and administrative framework that defines the scope of decommissioning under the relevant regulatory scheme. However, specification in the national law and regulations varies among the countries, from clearly defined to countries where these issues are hardly included in the legislation.

**It is recommended that the costs recognised for tax purposes are those drawn from elsewhere in government, such that there is no opportunity for disparity in the numbers.** See Annex G in relation to the current mechanisms by which decommissioning costs are estimated for non-tax purposes.

It is recommended that, where costs are deductible, there is clarity in the rules as to:

1. Which expenditure is allowable and which costs are disallowable; and
2. At what rate those costs are deductible (as countries may apply different tax rates to different streams of income).

In addition, there should be certainty that effective tax relief for allowable costs will be available.

*Estimating the costs of decommissioning*

In addition to agreeing the actual costs, Model 2 (and potentially Model 3, depending on how payments made into or out of the fund and income earned by the fund are taxed) will provide a tax deduction based upon the estimation of the costs of future decommissioning. Determination of the estimated costs of decommissioning is a technical matter, for which the best expertise is likely to reside within the appropriate resource ministry (mining or oil and gas). It is recommended that the tax deductibility be conditional upon approval of the estimated costs by the resource ministry and the notification by it to the tax administration. Governments may choose to address this matter through regulation.



It is also important for policy makers to recognize that the decommissioning costs estimate is an estimate only. The actual decommissioning costs at the end of the project life may be quite different due to a wide range of factors, including changes in technology, increases or decreases in labour or material costs, currency valuation changes, and the development of more innovative solutions and different environmental standards at the end of project life compared to the start. There needs to be a degree of flexibility built into the cost estimation process and in the consequent deductibility of such costs for adjustment of the estimate over the life of the project, and at the end of the decommissioning process.

### **Implications of security**

In addition to the taxation treatment of the decommissioning, a common factor in many regimes will be the requirement to provide security. Furthermore, given that requiring the setting up of funds can lead to capital being left idle and unavailable for investment, some governments have instead sought to address the risk by merely making sure that the funds are available to be called upon if needed. This results in the taxpayer obtaining security from:

- A bank, through a letter of credit;
- The parent company, through a guarantee; or
- A charge over assets.

Since the costs of obtaining these securities are effectively costs of decommissioning, these costs should be tax deductible in the same manner as costs for decommissioning or current costs, whichever is most appropriate. If tax relief is available on either a cash or an accrual basis, fees charged by the banks for letters of credit will be deductible as they are incurred.

In the case of a parent guarantee, where a fee is involved, it may or may not be deductible depending on the law of the country.

If the security is called upon and the bank then calls on the resources of the taxpayer, the calling by the bank should be treated in the same way as if the expenditure had been made by the taxpayer. If the security is called, care needs to be taken to avoid tax deductibility being given twice, i.e. once to the company and once to the bank.

## Tax policy legislative design

In common with other areas of tax treatment of the extractive sector, an initial issue to be decided is the location of the income tax provisions for the sector. There are various options, including:

- A separate omnibus law that is applicable to extractive industries which covers both tax and non-tax subjects;
- A chapter (or part) in the corporate income tax legislation that covers the extractive sector, and includes decommissioning related provisions;
- The sector legislation, meaning that the mining law and/or the oil and gas law, as appropriate, would have a tax chapter; or
- A contractual obligation between the government and the licensee.

The key consideration in the location of any legislation is that duplication should be avoided and definitions harmonized to the largest extent possible. This will particularly be the case where the country chooses to place the tax rules in the tax legislation, and the general decommissioning requirements in the sector legislation. Care needs to be taken to ensure that the tax law follows the definitions and tests used in the sector legislation, and does not seek to duplicate or create alternative tests for tax purposes, whether by statute or by regulations.

## Potential impacts of various tax issues on decommissioning

The tax regime can have the following behavioural impacts:

1. By taxing the profits from extraction, there is the natural consequence that a tax deduction is provided against the income for the costs incurred in earning that income, including those of decommissioning. Given that the decommissioning costs may only be payable late in the project life, there is a risk that governments may not plan appropriately or adequately recognise these costs.

Further, tax rules may:

2. Influence or even impede the choice of who actually does the decommissioning;

3. Prevent “time being your friend”—i.e. prevent future developments (such as technological breakthroughs) positively influencing decommissioning outcomes;
4. Encourage the removal of more equipment due to the future application of the precautionary principle ultimately requiring removal of equipment by the investor;
5. Promote premature decommissioning, e.g., through:
  - a. Restrictions on loss carry-backs;
  - b. Entity segregation for tax purposes, thus, restricting loss transfers; or
  - c. Restrictions of transfer of the resource asset to late life developers.
6. Promote only a standard decommissioning approach rather than a specifically designed approach;
7. Have an effect on the selection of the method of developing resource projects, thus, influencing the ultimate decommissioning method and approach;
8. Influence the premature shutdown of the infrastructure which will result in premature decommissioning of assets;
9. Stop alternative uses of resource fields and therefore promote premature closure or delay decommissioning; and
10. Advantage multi-field investors over single field investors, which will reduce the investor pool.

In case of Joint Development Areas (JDAs), different tax rules in the partner jurisdictions will add to the risk that incentives and obligations are misaligned, e.g. that costs are split disproportionately among the countries involved.

This section considers the incentives that the tax system can create. These are considered for the three models.

### ***Application to Model 1***

As noted above, for many mining projects, particularly open pit mines, it can be very difficult to start decommissioning except at the end of the mine’s life. This means that the vast majority of decommissioning costs will occur after the mine has stopped producing income. The

position is similar for oil and gas projects, although some elements of decommissioning can be undertaken during project life.

Consequently, the impact of Model 1 is the creation of a large tax loss once the mine or oil and gas field has stopped producing taxable income. At the most fundamental, the costs of decommissioning may not receive an effective tax deduction, even if the project has been profitable and the intention of the government has been that the project would be taxable on its overall profits (i.e., after all costs including decommissioning). Most tax systems will seek to mitigate this through allowing the decommissioning loss to be set off against profits elsewhere in the group or against the profits of a certain number of years before cessation. However, this is not wholly effective, as follows:

- The ability to offset the decommissioning costs against profits elsewhere in the group can reduce the impact for those groups with additional mining or oil and gas facilities that are profit making at the time of decommissioning. For these groups, the issue remains important, but generally only for the last asset. However, this option is not available for those companies with only one asset;
- The ability to carry decommissioning tax losses back against the taxable profits of the previous few years can reduce the impact, but this requires that there are sufficient profits in the years prior to cessation of production that are covered by the loss carry-back provisions. Ignoring any tax incentive, it can be expected that the last few years of ownership would be generating far less profit than earlier in the project and hence may not be sufficient to absorb the whole of the decommission costs.

As well as potentially meaning that the method is frustrating the government's intention to provide relief, this can also create the following key risks:

- Constraining the sale of late life assets:

The use of loss carry-back as the mechanism for relieving decommissioning costs requires the taxpayer to have a tax history of profits. This means that the sale of an asset to a new entrant could be impeded, as the new entrant would not inherit the profit history and might not generate sufficient profits in the

remaining period of ownership to offset the decommissioning costs. In practice, an incumbent owner might be willing to pay a new entrant to relieve it of the asset, but the potential denial or reduction of a tax deduction for decommissioning costs would impede such a transaction.

To some extent, this can be overcome by selling the company that operates the project, rather than the asset itself. However, this may be difficult to achieve commercially since this involves the purchaser taking on the risks inherent in the past, rather than just the asset. Furthermore, this can be constrained by legal restrictions on the sale of such companies and the involvement of minority shareholders.

A further example of this could be where a taxpayer transfers the asset but retains the obligation for decommissioning. In that case, the ability to carry-back losses may be lost or may give rise to an odd result. For example, if the decommissioning is carried out by the seller and the losses offset against profits far earlier in the ownership history (due to the recent history being in the hands of the buyer) the tax rate applicable to the deduction for decommissioning costs could be considerably higher or lower than that applied to the profit when earned.

➤ Promoting premature decommissioning:

If the period over which the loss can be carried back is not long enough, the taxpayer can be incentivised to decommission early—i.e. before the historic profits become insufficient to absorb the decommissioning costs or the tax rate applicable to the deduction reduces.

➤ Disadvantaging single mine/field investors:

The ability for multi-field investors to offset decommissioning costs incurred on one field against profits arising in other fields will provide an inherent disadvantage for single mine/field investors.

➤ Restricting change of use:

If the project is sold to a third party to use the mine or field for a different use (e.g. carbon capture and storage) then the new party may not have sufficient taxable profits to absorb the

decommissioning costs. Furthermore, the new use may be taxed at a different (lower) tax rate to the extraction activity and hence the decommissioning costs will be deductible at a rate lower than the extraction profits were taxed. Whilst the tax deductibility would be deferred, this would also defer the decommissioning costs and therefore could provide a cash flow benefit.

Furthermore, as the majority of mines or fields in a particular jurisdiction reach end of life, a concern will arise in the operator community that the tax provisions may be changed to restrict the carrying back of losses. Since no tax deduction has yet been provided, the amount of tax to be repaid may be considerable. In this environment, it will be important that it is generally accepted that the current government will honour the commitments of the government that provided the licence. If that is not accepted, then licence holders may be incentivised, for example, to decommission early so that those decommission activities are undertaken before any change of law. This will generally lead to a poor outcome for the country and hence care is needed to reinforce the certainty that the law will not be changed and the intentions of the original government frustrated.

The extent to which these concerns need to be addressed depends critically on the facts and circumstances of the jurisdiction. Options for addressing these concerns include:

➤ Longer periods for loss carry-back

Some countries will provide a longer period for carrying back of decommissioning losses than elsewhere in the tax system. This will help to address the concerns that a single mine/field operator would otherwise not be able to obtain appropriate deductibility for decommissioning costs and, thus, risking premature decommissioning, as it ensures that more of the mine/field's profits are available to offset the losses. However, this does not in itself address the constraint on sale of late life assets and may not address the restriction in change of use.

➤ Loss histories that follow the asset:

Some of the taxes operating in oil and gas apply on a field basis, rather than a company basis, such that the losses incurred will

result in the repayment of tax to whomever was the owner at the time. In this case, contractual arrangements can be entered between buyers and sellers to ensure that repayments are suitably allocated. It can be possible to deliver the same result in relation to taxes that are not on a field basis.

The precise options that are relevant depend critically on the nature of the tax regime and require specific consideration. Care will need to be taken to ensure that this does not result in the jurisdiction refunding more tax than has been paid on the field.

### *Application to Model 2*

The provision of a tax deduction on an accruals basis should address many of the risks inherent in Model 1, in that it provides effective deductibility to single mine/field operators, allows for transfer of the field since the tax effect to date will already have been provided, and reduces the change of law risk as there is less tax to be repaid at the end of life.

However, the following risks arise:

- Securing that decommissioning will occur and be funded:

Providing deductibility before the decommissioning has been undertaken creates the risk that the government will ultimately have provided a deduction for decommissioning that is not undertaken. This, however, is not a tax issue and should be addressed within the wider consideration of security over decommissioning obligations.

- Constraint on the use of funds:

In determining the use of the funds that have been reserved, it will be important that the decommissioning techniques available at the time of decommissioning govern, to avoid undermining any advances in technology. Hence, when the funds are utilised, the tax effects for any expenses previously accrued for decommissioning that are not required should be “recaptured.”

These risks can be addressed, depending on the nature of the tax system. Some systems<sup>209</sup> also provide for the increase in the

---

<sup>209</sup> For example, the United States mining regime under section 468 of the Code on Closure and Restoration (reclamation).

funds arising through interest. Where the interest is not taxed, the costs covered by such amounts are not deductible. This effectively addresses the concern, in part, that tax deductibility is provided early.

### ***Application to Model 3***

Again, the provision of a tax deduction upon contribution to the fund addresses many of the concerns highlighted in Model 1. The issues in relation to payments into and out of the fund, and the taxation of the fund itself have already been addressed. It will be important that the fund suffers no tax on expenditure that is incurred in relation to the decommissioning for which the fund has been set up.

As with Model 2, it will be important that the qualifying decommissioning costs are those determined when the decommissioning is undertaken, not at the time the fund was financed. Otherwise, the creation of the fund may require decommissioning techniques that are outdated.



## Annex A

### TAX TREATMENT OF DECOMMISSIONING EXPENSES IN ZAMBIA

#### A.1 Introduction

This Annex provides insights on the tax treatment of environmental restoration and rehabilitation costs in Zambia. It also provides an historical background to the current legislation.

#### A.2 Type of mining in Zambia

The mining industry is an economic and social backbone of Zambia. The major minerals produced include copper, cobalt, nickel, manganese, coal, emeralds, amethyst, beryl, lime stone, talc and uranium (though uranium is currently being stockpiled only). The major by-products from copper extraction are gold, platinum, palladium, selenium and silver.

The main mining methods include open pit, underground, solvent extraction and electrowinning.

#### A.3 Case study— environmental restoration costs

Mining companies in Zambia, as in most countries, are required<sup>210</sup> to undertake environmental impact assessment studies and make binding commitments through an environmental management plan to conserve and protect natural resources during and after cessation of mining activities.

Whilst this legislation had been in place under the Mines and Minerals Act since 1995, Zambia had until April 2006 no specific provisions in the Income Tax Act (ITA) that dealt with the environmental restoration and rehabilitation costs. Nonetheless the ITA had two general provisions that dealt with Environmental restoration expenses, namely:

---

<sup>210</sup> Under the Mines and Minerals Development Act (2015).

### *1- General Deduction Provision*

Section 29(1)(a) of the ITA is the general deduction provision and provides that:

in ascertaining business gains or profits in any charge year, there shall be deducted the losses and expenditure, other than of a capital nature incurred in that year wholly and exclusively for the purposes of the business.

The above provision requires that the environmental restoration and rehabilitation costs:

- (a) should *not* be of a capital nature; and
- (b) should be incurred in the relevant year to qualify for tax deduction.

Whilst the decision whether the outgoing is revenue or capital in nature is a debatable one, under Zambian tax cases, environmental restoration and rehabilitation costs were determined to be of a capital nature and thus not deductible under section 29(1)(a). Accordingly, one had to look to the provisions in the ITA applicable to capital expenditure deductions for mining companies.

### *2- Capital Expenditure Deduction*

Section 33(b) of the ITA is the principal provision for capital expenditure deductions incurred by Mining Companies. This Section provides that:

Capital allowances are deducted in ascertaining the gains or profit of a business and the emoluments of any employment or office for each charge year –

(...) (b) for capital expenditure in relation to mining operations, according to the provisions of Parts I to VI inclusive of the Fifth Schedule.

Part VI of the Fifth Schedule (Paragraph 19) defines qualifying capital expenditure as “expenditure, in relation to mining or prospecting operations (...) on buildings, works, railway lines or equipment (...)”.

The ITA does not have a definition of “works” and thus taking the ordinary meaning, the term includes environmental restoration and rehabilitation works.

Whilst the above definition of capital expenditure was sufficient, the complication in allowing deductions on environmental costs came in through paragraph 22(1) of the Fifth Schedule which provided that (emphasis added):

a deduction shall be allowed in determining the gains or profits from carrying on of mining operations by any person in a charge year in respect of the capital expenditure **incurred by the person on a mine which is in regular production in the charge year.**

Therefore, from the foregoing, environmental restoration and rehabilitation costs were deductible as capital expenditure provided that the expenditure had been incurred; and it had been incurred on a mine which was in regular production.

These two conditions were at the heart of concerns from the mining sector as it was not practical to commence environmental restoration and rehabilitation works on a mine that was in regular production. It was therefore contended that the legislation as it stood prior to the Tax Amendment of April 2006, effectively barred the right to deduct environmental restoration and rehabilitation expenditure.

*Current Tax Treatment (Tax Deduction Provisions after 1st April 2006)*

To address the undesirable effects of the Tax Law, amendments were made effective April 2006. The following is the current law:

A deduction is allowed in ascertaining the gains or profits of a person involved in mining operations in respect of actual costs incurred by way of restoration and rehabilitation works or amounts paid into the Environmental Protection Fund, (this fund is administered and managed by the Environmental Protection Fund Committee that is appointed by the Minister Responsible for Mines). Only actual costs are deductible and therefore provisions are not allowable in determining taxable profits.

Additionally, amounts refunded from the Environmental Protection Fund to any person carrying on mining operations are recognised as income in the year the refund is made and hence qualify to be taxed.

The extracts of relevant provisions under the Income Tax Act are given below.

***First Schedule to the Income Tax Act  
(Further Classification of Income)***

**Paragraph 9**

Amounts refunded to any person carrying on mining operations pursuant to paragraph (a) of subsection eighty-six of the Mines and Minerals Development Act, 2015 shall be deemed to be income in the year that the refund is made.

**Fifth Schedule to the Income Tax Act  
(Mining expenditure deductions)**

**Paragraph 22(3)**

A deduction shall be allowed in ascertaining gains or profits of a person involved in mining operations in respect of actual costs incurred by way of restoration and rehabilitation works or amounts paid into the Environmental Protection Fund pursuant to section eight-six of the Mines and Minerals Development Act, 2015.

## Annex B

### TAX TREATMENT OF DECOMMISSIONING EXPENSES IN SOUTH AFRICA

#### B.1 Income tax rules relating to rehabilitation of the environment

Mining rehabilitation expenditure consists of two components, ongoing environmental rehabilitation expenses and expenses in respect of closure or decommissioning of mining projects. Although both components are required to be expended in terms of National legislation (NEMA<sup>211</sup> and MPRDA<sup>212</sup>) the tax effects are not the same.

In the case of ongoing rehabilitation expenses, a tax deduction is normally allowed under the general deduction formula in the Income Tax Act<sup>213</sup> (IT Act) in the year the expenditure is actually incurred.

Closure and decommissioning costs quantified and provided for in accordance with the requirements of MPRDA and NEMA relate to expenditure to be incurred in future and cannot be claimed for income tax purposes until they have been actually incurred. The IT Act specifically prohibits the deduction of provisioning for future expenses.<sup>214</sup> A further aspect to be noted is that expenditure on decommissioning and environmental rehabilitation incurred after an extractive company ceases with its mining activities may not be deductible for income tax purposes. The reasons are that trading activities may have ceased and the general deduction formula does not allow a deduction if trade is not carried on or the expenditure is not incurred in the

---

<sup>211</sup> National Environmental Management Act (Act 107 of 1998) (NEMA).

<sup>212</sup> Mineral and Petroleum Resources Development Act (Act 28 of 2002) (MPRDA).

<sup>213</sup> Section 11(a) of the Income Tax Act (Act 58 of 1962) allows a deduction from the income derived by a person from carrying on a trade of expenditure and losses actually incurred in the production of the income if the expenditure and losses are not of a capital nature.

<sup>214</sup> Section 23(e) of the Income Tax Act provides that no deduction shall be made of income carried to any reserve fund or capitalized in any way.

production of income. Closer to the end of the life of a mine or oil and gas field the expenses (including decommissioning and rehabilitation) would exceed income earned and even if expenditure can be deducted the benefit of assessed losses are forfeited. The South African tax system does not allow the carry-back of tax losses by a taxpayer and tax losses cannot be carried forward to future tax years if the company is no longer trading.<sup>215</sup>

Mining and oil and gas extractive companies have the option of utilising funding vehicles described in section 37A of the IT Act to earmark assets for all or part of the required *financial provision* for rehabilitation, decommissioning and closure and remediation of latent or residual environmental impacts. The use of these funding vehicles enables extractive companies to comply with their *financial provision* obligations under MPRDA and NEMA in a tax efficient manner.

## B.2 Closure rehabilitation trusts and companies

To encourage and facilitate preservation of funds for environmental rehabilitation and decommissioning activities, the tax system provides tax benefits in relation to a closure rehabilitation trust or company<sup>216</sup>. A qualifying trust or a company used as a funding vehicle results in tax deductible contributions to the vehicle and a tax exemption of receipts and accruals of the vehicle.<sup>217</sup>

Legislative requirements are set on the type of contribution, the type of funding vehicle, the persons that may make deductible contributions, assets that may be owned, utilisation of assets, excess assets after closure rehabilitation and contravention of legislative provisions.

### *Type of contribution*

Only amounts in cash may be paid to the funding vehicle. Therefore, the transfer of assets such as shares, financial instruments or tangible property is not allowed. This could conceivably still occur but the donor or transferee will not be able to deduct the value of such donation or transfer in terms of section 37A of the IT Act.

---

<sup>215</sup> Section 20(1) of the Income Tax Act.

<sup>216</sup> Section 37A of the Income Tax Act.

<sup>217</sup> Section 10(1)(c) of the Income Tax Act.

*Type of funding vehicle*

Only a trust<sup>218</sup> or a company may qualify as a funding vehicle. The sole object of the trust or company must be to apply its property solely for rehabilitation upon premature closure, decommissioning and final closure, and post closure coverage of any latent and residual environmental impacts on the area covered in terms of any permit or right in respect of prospecting, exploration, mining or production, or reservation or permission for or right to the use of the surface of land as contemplated in paragraph 9 of Schedule II to the MPRDA to restore one or more areas to their natural or predetermined state, or to a land use which conforms to the generally accepted principle of sustainable development.<sup>219</sup>

Any distributions by the trust or company must be solely for purposes described in its sole object or in certain circumstances to a similar trust or company.<sup>220</sup>

The constitution of the company or the instrument establishing the trust must incorporate the provisions of section 37A.<sup>221</sup>

*Persons that may make deductible contributions*<sup>222</sup>

Mining and oil and gas extractive companies that:

- hold a permit or right in respect of prospecting, exploration, mining or production, or reservation or permission for or right to the use of the surface of land as contemplated in paragraph 9 of Schedule II to the MPRDA; or
- are engaged in prospecting, exploration, mining or production in terms of any permit, right, reservation or permission referred to in the previous bullet.

After approval by the Commissioner for the South African Revenue Service, the extractive company may pay an amount in cash

---

<sup>218</sup> A trust is not a legal person as it is not an independent entity. Any property held in trust is held by the trustee in his/her capacity as trustee. The Income Tax Act specifically includes a trust in the definition of a person.

<sup>219</sup> Section 37A(1)(a) of the Income Tax Act.

<sup>220</sup> Section 37A(1)(c) of the Income Tax Act.

<sup>221</sup> Section 37A(5) of the Income Tax Act.

<sup>222</sup> Section 37A(1)(d) of the Income Tax Act.

to the closure trust or company on condition that the payment was not part of any transaction, operation or scheme designed solely or mainly for purposes of shifting the tax deduction from another person to the extractive company making the payment.

### *Assets that may be owned*

The closure trust or company may only own permitted assets. These permitted assets are limited to:

- financial instruments issued by South African regulated collective investment schemes, long-term insurers, banks and mutual banks;
- financial instruments in listed companies,<sup>223</sup> unless the company is making contributions to the closure trust or company or the company is a connected person<sup>224</sup> in relation to the company making contributions to the closure trust or company; and
- financial instruments issued by any sphere of government of South Africa.

The tax policy objective is to limit permitted asset to assets that are relatively liquid and easy to value (for the benefit of regulatory oversight).

### *Utilisation of assets*

The closure trust or company must use all of its assets solely for purposes of its sole objective of rehabilitation upon premature closure, decommissioning and final closure, and post closure coverage of any latent and residual environmental impacts on the area covered in terms of any permit or right in respect of prospecting, exploration, mining or production, or reservation or permission for or right to the use of the surface of land as contemplated in paragraph 9 of Schedule II to the MPRDA to restore one or more areas to their natural or pre-determined state, or to a land use which conforms to the generally

---

<sup>223</sup> The definition of listed company in section 1(1) of the Income Tax Act refers to companies listed on the JSE (previously the JSE Securities Exchange and the Johannesburg Stock Exchange) or a recognised offshore exchange.

<sup>224</sup> Connected person is defined in section 1(1) of the Income Tax Act.



accepted principle of sustainable development of mining rehabilitation upon closure.<sup>225</sup>

*Excess assets after closure rehabilitation*

When the Minister of Mineral Resources is satisfied that all of the areas relating to any permit, right, reservation or permission of the persons contributing to the closure trust or company have been rehabilitated as set out on the object of the trust or company, the company or trust in respect of those areas must be wound-up or liquidated and its assets remaining after the satisfaction of its liabilities must be transferred to another closure trust or company as approved by the Commissioner for the South African Revenue Service or to an account or trust prescribed by the Minister of Mineral Resources and subject to approval by the Commissioner for the South African Revenue Service.<sup>226</sup>

Excess assets held by closure trusts or companies (i.e. amounts exceeding the anticipated mining rehabilitation liability) can also be transferred to other similar closure trusts or companies before termination if the Minister of Mineral Resources is satisfied that the closure trust or company will be able to satisfy all of its rehabilitation liabilities and it has sufficient assets to rehabilitate and restore all of the areas relating to any permit, right, reservation or permission of the persons contributing to the closure trust or company as set out on the object of the trust or company and the Commissioner for the South African Revenue Service approves the transfer.<sup>227</sup>

*Contravention of legislative provisions*

If a closure trust or company owns any impermissible assets, an amount of taxable income equal to the market value of the impermissible assets become taxable in the hands of the mining or oil and gas extractive company contributing to the closure trust or company to the extent that the impermissible assets are (directly or indirectly) derived from cash paid by that extractive company.<sup>228</sup>

---

<sup>225</sup> Section 37A(1)(b) of the Income Tax Act.

<sup>226</sup> Section 37A(3) of the Income Tax Act.

<sup>227</sup> Section 37A(4) of the Income Tax Act.

<sup>228</sup> Section 37A(6) of the Income Tax Act.

If a closure trust or company distributes assets for a purpose other than:

- (a) rehabilitation upon premature closure;
- (b) decommissioning and final closure;
- (c) post closure coverage of any latent or residual environmental impacts; or
- (d) transfer to another closure trust or company, an amount equal to the market value of assets that was so distributed is deemed to be an amount of taxable income for the closure trust or company.<sup>229</sup>

If the Commissioner for the South African Revenue Service is satisfied that a closure trust or company has contravened any provision of section 37A of the IT Act, the Commissioner may treat an amount equal to twice the market value of all of the assets held in that trust or company on the date of that contravention as taxable income in the hands of the mining or oil and gas extractive company contributing to the closure trust or company for the tax year during which the contravention occurred to the extent that the assets are (directly or indirectly) derived from cash paid by that extractive company.<sup>230</sup>

### B.3 Deduction of expenditure of oil and gas companies

An oil and gas company<sup>231</sup> may deduct environmental rehabilitation expenditure incurred in respect of exploration<sup>232</sup> or post-exploration<sup>233</sup>

---

<sup>229</sup> Section 37A(7) of the Income Tax Act.

<sup>230</sup> Section 37A(8) of the Income Tax Act.

<sup>231</sup> An oil and gas company is defined in paragraph 1 to mean any company that holds any specified oil and gas right granted under the MPRDA, or engages in exploration or post-exploration in terms of any oil and gas right.

<sup>232</sup> Exploration is defined in paragraph 1 to mean the acquisition, processing and analysis of geological and geophysical data or the undertaking of activities in verifying the presence or absence of hydrocarbons (up to and including the appraisal phase) conducted for the purpose of determining whether a reservoir is economically feasible to develop.

<sup>233</sup> Post-exploration is defined in paragraph 1 to mean any activity carried out after the completion of the appraisal phase, including:

activities against its oil and gas income.<sup>234</sup> The deduction of exploration or post-exploration expenditure<sup>235</sup> is limited to oil and gas income derived during the tax year, or future tax years in the case the deductions result in assessed losses. Therefore, environmental rehabilitation and decommissioning expenditure incurred after cessation of production will not be deductible as no oil and gas income is derived.

The benefit of a deduction under paragraph 5 of the Tenth Schedule to the Income Tax Act is that an additional deduction<sup>236</sup> is allowed against oil and gas income on the basis of:

- (a) 100 per cent of all expenditure of a capital nature actually incurred in that year of assessment in respect of exploration in terms of an oil and gas right; and
- (b) 50 per cent of all expenditure of a capital nature actually incurred in that year of assessment in respect of post-exploration in respect of an oil and gas right.

- 
- (a) the separation of oil and gas condensates;
  - (b) the drying of gas; and
  - (c) the removal of non-hydrocarbon constituents, to the extent that these processes are preliminary to refining.

**234** Oil and gas income is defined in paragraph 1 to mean the receipts and accruals derived by an oil and gas company from:

- (a) exploration in terms of any oil and gas right;
- (b) post-exploration in respect of any oil and gas right; or
- (c) the leasing or disposal of any oil and gas right.

**235** Paragraph 5 of the Tenth Schedule to the Income Tax Act read with section 26B of that Act.

**236** Paragraph 5(2) of the Tenth Schedule to the Income Tax Act.

## Annex C

### NATIONAL AND INTERNATIONAL LEGAL REQUIREMENTS

#### C.1 International oil and gas legal requirements for decommissioning

Since 1958, international conventions have stated that all offshore platforms must be decommissioned at the end of the field life. As the complexity of the offshore oil and gas facilities has evolved, the challenge to balance the total removal with environment, safety, technical feasibility, cost etc. has forced an evolution in the decommissioning law and regulations.

The optimal solution may not be total removal of a specific oil and gas facility, but a carefully balanced compromise within the relevant legal framework. It is important that governments incorporate flexibility in their national legal framework. The present international laws and conventions, listed below, are applicable in most of the countries and have built in such flexibility:

- United Nations Convention on the Continental Shelf, 1958<sup>237</sup>
- Third United Nations Convention on the Law of the Sea, 1982, UNCLOS III<sup>238</sup>
- “The International Maritime Organisation Guidelines and Standards for the Removal of Offshore Installations and Structures on the Continental Shelf and in the Exclusive Economic Zone”, 1989 (a.k.a. IMO Guidelines)<sup>239</sup>

---

<sup>237</sup> Available at <https://treaties.un.org/doc/publication/mtdsg/volume%20ii/chapter%20xxi/xxi-4.en.pdf>.

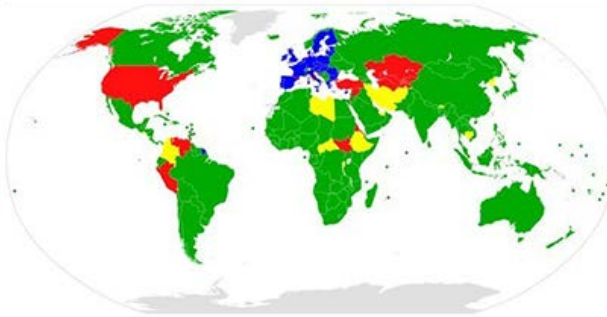
<sup>238</sup> Available at [www.un.org/depts/los/convention\\_agreements/texts/unclos/unclos\\_e.pdf](http://www.un.org/depts/los/convention_agreements/texts/unclos/unclos_e.pdf).

<sup>239</sup> Available at <https://cil.nus.edu.sg/wp-content/uploads/formidable/18/1989-Guidelines-and-Standards-for-the-Removal-of-Offshore-Installations-and-Structures-on-the-Continental-Shelf-and-in-the-Exclusive-Economic-Zone.pdf>.

- “Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matter “, 1972 (a.k.a. London Dumping Convention -LDC).<sup>240</sup>
- “1996 Protocol to the Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matters” (a.k.a. London Protocol)<sup>241</sup>

Figure VI.C1:

**United Nations Convention on the Law of the Sea**



■ Parties    ■ Parties dually represented by the European Union  
■ Signatories    ■ Non-parties

Source: UN/DESA.

These international laws and regulations are supplemented by relevant national and state legalisation. The national and state legalisation can impact on decommissioning of oil and gas facilities, under environmental, safety, waste management, socio-economic and tax and customs laws etc. Furthermore, due to the potential socio-economic impacts, the decommissioning of redundant oil and gas facilities may often become a regional issue.

The decommissioning of pipelines in the oil and gas industry is not covered in international law and usually this issue is managed in

<sup>240</sup> Available at <http://www.imo.org/en/OurWork/Environment/LCLP/Documents/LC1972.pdf>.

<sup>241</sup> Available at [http://www.gc.noaa.gov/documents/gcil\\_lp.pdf](http://www.gc.noaa.gov/documents/gcil_lp.pdf); <http://www.imo.org/en/OurWork/Environment/PollutionPrevention/Pages/1996-Protocol-to-the-Convention-on-the-Prevention-of-Marine-Pollution-by-Dumping-of-Wastes-and-Other-Matter,-1972.aspx>.

national legalisation. But for pipelines there are two clear principles in international law:<sup>242</sup>

- No interference with navigation, fishing and other users of the sea; and
- All appropriate measures must be taken for the protection of the living resources of the sea from harmful agents.

These are the guiding principles of the countries national law regimens, which cover pipelines.

For installations located onshore, sectoral, regional and national laws and regulations are applicable.

## C.2 International best practices for mine closure

National mine closure policy is usually dictated in its national constitution that mandates a healthy environment for its citizens or by requirements of international treaties and agreements. At the national level, individual national sectoral policies and legislation (other than those for environment and mining), various Executive Decrees and specific Local Government Agreements (often with industry), all must be provided for as part of an overall national programme for acceptable mine closure. These are in addition to specific instruments under Environmental and Mining legislation that require putting in place policy and legislation for Environmental Impact Assessments, Social Impact Assessments, Mining Plans, Standard Mining Agreements, bonding procedures and providing for Inter-Ministerial Agreements to achieve comprehensive mine closure and sustainable development.

Many countries do not have provisions for mine closure in their mining laws. Few governments have actual mine closure legislation. Where mine closure legislation is enacted, it is primarily with respect to reclamation and rehabilitation.

---

<sup>242</sup> *Geneva Conventions on the Law of the Sea* (1958). Available at <http://legal.un.org/avl/ha/gclos/gclos.html>. *United Nations Convention on the Law of the Sea—UNCLOS* (1982). Available at [http://www.un.org/depts/los/convention\\_agreements/convention\\_overview\\_convention.htm](http://www.un.org/depts/los/convention_agreements/convention_overview_convention.htm); *International Maritime Organization—International Convention on Salvage* (1989). Available at <http://www.imo.org/en/About/Conventions/ListOfConventions/Pages/International-Convention-on-Salvage.aspx>.

Comprehensive mine closure and all that it entails would simply be part of any mining planning and design if the life cycle of a mine was full considered before establishing the mine. However, history and present practices in many countries clearly demonstrates that this is not the case.

Countries which have enacted national mining closure law typically do so by including it directly in the national Mining Law or indirectly within the national Environmental Law but also within their Foreign Investment Laws for comprehensive mine closure. Compliance with these provisions is often a pre-condition of acquiring mining licence rather than a matter of “best practices” which would be a far better approach. In some countries, their legislation contains only general statements with respect to “appropriate” or “reasonable” reclamation and rehabilitation with the specific issues related to mine closure normally being dealt with on an “ad hoc” basis.

In practice, however, rehabilitation, reclamation and mine closure plans vary greatly among and within individual countries, as do the requirements for bonding or other surety instruments to ensure that the plans are carried out.

The level of provision for mine closure within the mining laws and regulations of the developing countries is largely dependent on three factors, i.e.:

- The age of the country’s mining law and regulations;
- The activities of past mining enterprises; and
- Related policy and legislation, in particular, environmental policy and legislation.

Many developing countries in Africa, Latin and South America and Asia, each with a long mining history of private sector mineral development, are characterized by having:

- A very general policy and legislation for mine closure;
- A high degree of state responsibility for both abandoned and some operational mines; and
- Few, if any, bonding procedures to ensure comprehensive mine closure and providing for mine closure on a negotiated “mine-by-mine” basis.

However, some developing countries, such as Bolivia, Mali, Namibia and Zambia can be said to have comprehensive policy and legislation that provides for comprehensive mine closure and for post-mining sustainable development.

It is often the case that inadequate and unproven fiscal regimes exist in countries where post-closure sustainable development presents the greatest challenge for the government. One of the key fiscal regimes is a taxation system which facilitates this process.

In summary, the sector law and regulations for decommissioning provide the overall framework within which the taxation rules for decommissioning must be designed.



## Annex D

### POLITICS, PUBLIC CONCERN AND REPUTATION

As discussed above, the effects resulting from the political and community reaction to the closure of major facilities in a community can heavily influence the decommissioning process. If not properly managed, a destructive distrust can develop between the principal players. If any indication of non-disclosure emerges, this can lead to catastrophic outcomes, such as the Brent Spar incident.

It is advised that the selection of the decommissioning/closure option must be managed in a transparent process with a fully developed public audit trail. The three major components that need to be managed are:

- National and local politics;
- Public concern; and
- Reputation.

The development of proper decommissioning and closure process includes guidance from stakeholder groups representing all national and local interests including representatives from the oil and gas and fishing industries, environmental non-governmental organisations, as well as government officials in the areas of mining/oil and gas regulation, mining/oil and gas safety, fishing, navigation and all affected users of the land and the sea in the region.

The objectives of a stakeholder policy development process usually are:

- To develop:
  - principles/guidelines to apply to the closure/decommissioning of existing facilities;
  - principles/guidelines to apply to the design, operation and future closure/decommissioning of new facilities; and
  - to the extent possible, consensus between stakeholders.
- To provide:
  - regulators (both Designated Authorities, the Department

- of the Environment and Water Resources and others) with guidance on how applications for closure/decommissioning are to be assessed;
- industry with guidance as to what will be expected of them in respect of closure/decommissioning, with the aim of reducing risk and uncertainty; and
  - opportunity for public comment and involvement in the development of government policy.
- Recognition of possible future liabilities and how they could be managed.

## Annex E

### STAKEHOLDERS

Decommissioning is expected to attract increasing interest from parties both within and outside the industry, particularly regarding issues on environmental, social and economic impact. The industry operates within a regulated legal framework overseen by national regulator(s).

The framework seeks to achieve effective and balanced solutions for decommissioning activities. These solutions need to be consistent with each nation's international obligation (treaties) and have a proper regard for safety, environment, other legitimate users of the land and/or sea, and economic as well as social considerations.

An important part of the decommissioning process is the mapping and issues identification of key stakeholders, and to provide a general advice on future stakeholder engagement. Stakeholders will have a specific and defined interest in the decommissioning activities, either because they could be impacted by the decision, and/or they can have an impact or influence on the planned activity.

Involving or engaging stakeholders can take a range of different forms, including information giving, consultation or dialogue.

The design of a stakeholder engagement plan or guidelines could be a useful tool to demonstrate how engagement is an integral part of achieving a robust, sustainable and acceptable decommissioning programme. The guidelines set out the benefits of good engagement for the operators and stakeholders alike.

Key questions in a stakeholder engagement process are:

- Which stakeholders to engage?
- How to engage?
- When to engage?

Well managed stakeholder engagement can improve decommissioning plans and make the whole process more efficient. Stakeholder engagement can make the outcomes of the decommissioning project more sustainable. It can be cost efficient and reduce the potential for

conflict when done properly. The essential characteristic of stakeholder engagement is that it seeks an effective and balanced decommissioning solution.

The key stakeholders are the governments of resource-rich countries, specifically the regulatory authorities, institutions, and ministries responsible for:

- administering mineral resource and oil and gas extraction contracts;
- issuing environmental permits for exploration, exploitation, and closure; and
- ensuring that legal, financial and technical measures are in place to address temporary shutdowns as well as complete closure and decommissioning at the end of the productive life of oil and gas and mining operations.

A list of stakeholders would include:

- Government/Authorities & Representatives/ Legislators including:
  - National (Ministries and Agencies);
  - Regional / District; and
  - Local (Port Authorities, Local communities);
- International and Regional Regulators;
- Commercial Interest Groups including:
  - Decommissioning Supply Industry;
  - Local Industry;
  - Investors; and
  - Unions/Employee Organizations;
- Public/the Wider Citizenry, including:
  - NGO groups;
    - Environmental; and
    - Marine Life;
  - Other Users of the Sea;
    - Shipping & Navigation;
    - Fishing Industry;

- Tourist Industry; and
- Navy;
- Media; and
- Universities and Research Organizations.

Some of these interests would be less relevant for land based activities such as onshore mining, and other interests and interest groups would be relevant in their place.

## Annex F

### ENVIRONMENTAL IMPACT

Once closure and decommissioning strategies have been decided upon, it will be necessary to develop an Environmental Impact Assessment for the relevant options, rank the options and to communicate the outcome to various stakeholders. No mine shutdown or decommissioning study would be complete without a proper impact assessment.

The purpose of an impact assessment is to clarify the effects of measures that may have significant consequences for the environment, natural resources, and society. The impact shall ensure that these effects are taken into account when the measure is planned and when decisions are reached regarding whether, and on what conditions, the measure may be carried out.

Examples of environmental drivers are:

- Protection of the environment;
- Precautionary Principle;
- Definition of end state (e.g. how clean is clean);
- Grandfathering;
- Understanding and managing emission paths;
- Characterization and management of waste; and
- Decommissioning plan and measurement of impacts.

The inclusion of the correct stakeholder group is essential in the environmental impact assessment. The group can consider the balancing of different policy priorities and set the standard for the assessment that is appropriate to national needs, and in line with national policy priorities. It is important to recognize that there is a trade-off to be achieved, and ultimately sovereign countries must determine the standard to be achieved, while bearing in mind international minimum goals. The more clarity and certainty that can be provided up front on what will be considered and who will be responsible, the better.

## Annex G

### QUANTIFICATION OF DECOMMISSIONING COSTS

#### G.1 Framework of quantification

International and regional legal frameworks drive the cost of decommissioning and remediation, assuming that the country has ratified the relevant treaties and agreements. This international legal framework defines what must be removed, when it must be removed, to what degree the sites need to be reclaimed and rehabilitated. But these laws and regulations are very high level and rely on, when available, the more detailed national and state law, regulation and guidelines.

These country specific laws, regulations and guidelines are used to define the decommissioning and rehabilitation specifications in technical and environmental terms. These specifications are the basis of the final engineering and environmental solutions, which generate the decommissioning cost estimates. Accurate decommissioning costs are critical as, if there is a shortfall in accrued provision at the end of the life of the oil and gas field and mines, the state and the other partners will have to fund this shortfall.

Usually mining and oil and gas companies generate the decommissioning cost estimates and hence the provision for such decommissioning, since they are operating the facilities.

In a relevant international accounting standard (IAS 37 on Provisions, Contingent Liabilities and Contingent Assets<sup>243</sup>) the annual accounts must have a provision for the liability for the decommissioning of redundant facilities and remediation.

#### G.2 Costs

##### *General*

Decommissioning cost in the oil and gas industry worldwide is estimated to be in the billions of dollars and the trend is increasing.

---

<sup>243</sup> See, for example, <https://www.ifrs.org/issued-standards/list-of-standards/ias-37-provisions-contingent-liabilities-and-contingent-assets/>.

Planned costs have often been lower than actual costs, especially for the bigger operations.

The costs have risen in recent years due to stricter sectoral, national and international legal frameworks, higher HSE scrutiny, increased focus on well operations and plug and abandonment (P&A) activities, limited experience in complicated operations, final disposal and requirements to recycle more. Decommissioning costs can be reduced by establishment of a more flexible national and international legal framework, new technology, more cost-effective ways to organize the removal process, include decommissioning in the early planning phase of a project—life cycle perspectives, economic of scale and bundling of projects.

Potential charge of costs incurred for staff utilisation and know-how developed elsewhere should also be considered when assessing specific fields or projects.

### *Cost estimation in the oil and gas industry*

Sources of data on estimating decommissioning costs in the oil and gas sector describe the possibilities and limitations of using the various available sources for cost savings estimates.

Oil and gas operators make periodic assessments on their expected decommissioning costs as a basis for their provision requirements. These are generally calculated for individual platforms using a *quantity x resource x time*-method. The quantity (jacket and top side weight) is calculated once while the rate (price per unit) and time (heavy lift vessels duration in days) are updated on a regular basis. Some operators make these calculations in-house with their own cost models that might be based on benchmark data. Other operators use external engineering consultants to make cost estimates. For structures where decommissioning is expected to occur on a medium to long-term basis, these calculations tend to be based on a cost per unit. For structures where the decommissioning date lies closer to the present, the calculations will be more detailed.

There is no agreed standard established by the industry.



*Cost estimation in the mining industry*

Practice in the mining industry differs considerably. Chilean law<sup>244</sup> requires that mining companies provide financial guarantees for the closure of currently active and future mining operations. The value of the guarantee is to be based on the estimated closure cost for the mine (presented in the closure plan) and the planned operating life of the mine. The responsibility for reviewing and approving both the closure plan and the estimate of closure costs falls to the Chilean government mining and geology agency, called *Servicio Nacional de Geología y Minería* (SERNAGEOMIN).

A national guide for the estimation of closure costs in Chile has been developed. The core of the guide is a cost estimation model that calculates costs based on a breakdown of the mine into a limited number of costing components and takes into account key modifying factors that are used to adjust costs, such as local geography, accessibility, and elevation.

The value of the guarantee is based on the estimated closure cost for the project, including both the execution of closure measures at the end of mine life, and a fund for the execution of post-closure measures after the completion of major closure works.

International practice in the determination of the quantum of financial provision for mine rehabilitation and closure differs.

The practices and methodologies from the selected countries can be categorized as follows:

- Area-based, that is the quantum for financial provision is calculated by multiplying the area of the mining operations by a fixed standardised unit rehabilitation cost; and/or
- Project-based, where the costs of each component of rehabilitation of the mine site are determined and totalled for the life of the mine.

---

<sup>244</sup>Law 20.551 on the Closure of Mines: Available in Spanish at <https://www.leychile.cl/Navegar?idNorma=1032158><https://www.leychile.cl/Navegar?idNorma=1032158>.

### **G.3 Accurate estimation of costs/ prudent provision reporting.**

Specific decommissioning plans and associated cost estimates are generally set out in regulations that have their basis in national legislation. Which of the associated costs should be included in the decommissioning cost estimate is governed by the legal and administrative framework that defines the scope of decommissioning under the relevant regulatory scheme. However, specification in the national law and regulations varies among countries, from cases where it is clearly defined to cases where these issues are hardly included into the legislation.

The cost estimates are important for ascertaining that necessary funds are available to cover the actual costs of decommissioning the installations.

There is considerable difference in the format, content and practice of cost estimates, which makes it challenging to compare estimates, even for similar types of installations. The reasons are largely differing legal requirements in various countries and established practice.

Owners/licencees are generally responsible for developing cost estimates and funding mechanisms. They are required to submit the estimates to the regulator for review or approval.

The types and extent of assumptions and boundary conditions typically applied in cost estimates have a major effect on the overall costs. Regulators can specify boundary assumptions as a way of ensuring completeness in the coverage of the cost estimates, as well as the quality of the analysis. This could limit cost underestimation and over-provision, given that the regulator has the right knowledge and competence.

Standard definitions of cost items should be established. Development of an international guideline or standard list of items for cost estimation, could establish more consistency and comparability if countries used common or comparable definitions of cost elements and cost groups.

Developing valid cost estimates requires not only good definitions and specific assumptions, but also good data; hence, the accuracy of cost estimates depends both on the methods used and quality of the data.

In some industries, quality control by the regulator is established as an important reference point for validation of cost estimates: regular tracking of costs, benchmarking of actual experience against the cost estimates and requiring full documentation from the operator of how the cost estimate was developed.

The aim should be to develop a standard tool or procedure by which national cost estimates could be mapped for the purpose of comparison primarily nationally, but also internationally. One advantage of such comparison is to create more transparency of cost estimates and build confidence in the estimating basis.

## Annex H

### APPLIED TAX TREATMENT ISSUES IN DECOMMISSIONING

#### H.1 Accounting for costs

In accounting for decommissioning costs, it will be necessary to consider the general rules for accounting for costs. It is of course logical that the approach taken by the country in handling project related costs, e.g., in a cost sharing contract, be followed for the sake of consistency.

Further, policymakers should also consider whether decommissioning costs should be deductible on an entity or a project basis, especially where a deductible provision solution is opted for, or in cases where the overall natural resource extraction regime is based on ring-fencing of reserves. The guidance provided on accounting of costs in Chapter 7 of this Handbook (The Government's Fiscal Take) also needs to be borne in mind.

The accounting currency for decommissioning costs may be a specific challenge, as they will typically be in hard currency, while the accounting currency will usually be the national currency of the project country. This will not be significant issue where deduction is available and is made on an ongoing basis, or even in the use of funded mechanisms, especially if the fund is managed in hard currency. However, there may be a significant mismatch where accruals-based provision is made, and policymakers will have to decide, in cases where the actual cost in hard currency exceeds the provision made, whether to allow the excess relief in the year of disbursement or over the life of the project. The same consideration should then apply to all recapture of excess provision made.

It is recommended that any foreign exchange gains and losses on disbursements from a fund set up under a funded deduction mechanism be explicitly kept out of the capital gains tax regime. Any such gains and losses will be reflected in the net balance of the fund, which would be subject to the recapture provisions in cases of excess deduction.

To the extent that a company has set up a decommissioning provision and is expecting to receive tax deductibility at a future date, such as in Model 1, the accounts will recognise a deferred tax asset which represents the tax effect that will arise from the deduction for qualifying decommissioning expenditure that has been accrued.

## **H.2 Allowability of costs**

### *General principles*

In general, deductibility will follow the tax policy approach chosen. However, there needs to be provision for allowance for excess costs over the planned and agreed costs if such costs occur, and for recapture of excess provision allowed.

### *Complex cases*

The tax deductibility of decommissioning costs, and the recapture of excess provisions in accrual provision regimes, will be particularly complex in the case of single block/field operators. In this situation, the operator will have no operating income in the country and will have little incentive to fulfil its obligations, beyond the risk to its general reputation. It may be useful to consider a mix of instruments as a solution, e.g. the availability of loss carry-backs for such operators, subject to approval by the tax authority.

Another possible area of complexity will be deductibility of costs for decommissioning of ancillary and supplementary equipment that is not the operator's property, e.g., those owned by subcontractors or partners. It is necessary to take a flexible approach to these issues and to leave scope to permit deductibility on a case by case, where the expense is actually incurred.

A further challenge may come from costs incurred that are strictly speaking not for decommissioning, e.g., for repurposing of fields, something which is not uncommon for the mining sector. It is possible that, in some cases, good planning can lead to continued use of an extractive sector project for some completely different purpose, e.g., the conversion of open pit mines into a lake with fisheries or tourism potential. The technical argument here will be whether such expenditure is of a revenue nature (i.e., for decommissioning) or

a capital cost (development of a new facility), especially if the same owner or a related company continues to operate the facility. It is recommended that a flexible approach be taken, and the tax treatment decided in a manner that balances the need to encourage more efficient use of sites with the need to raise revenue.

### *Multiple operator cases/combined fields.*

Another complex area can be that of multiple operators who partner in a single field area. One operator may have other income from the jurisdiction while the other operator may only have one project. The first operator may wish to see ongoing deduction of decommissioning costs, while the latter would probably prefer an accrued provision. Again, a flexible approach, based on the accurate estimation of costs, and controls to ensure that both operators will perform their obligations, can enable policymakers to create a “win-win” situation that will allow both operators to make the most efficient use of their resources.

A related challenge can be multiple operators who manage contiguous fields, but utilize common facilities such as pipelines. The problem can be particularly aggravated if the fields in question have different expected lives, as the operator in the field with the lower expected life have less time to provide for its share of decommissioning costs of common facilities, and more importantly, will probably be absent from the country when the pipeline needs to be decommissioned. In such cases, the decommissioning plan needs to be agreed with both (or multiple) parties and respective shares allocated. A funded mechanism with oversight from both parties is probably the best solution.

## **H.3 VAT/GST and services tax issues around decommissioning**

VAT/GST and other indirect taxes on services will also impact decommissioning. Please refer to Chapter 9 of this Handbook (Value Added Taxation Issues) for further information.

## **H.4 International tax issues**

### *Tax treatment issues in Joint Development Areas and Contiguous Fields*

The tax regimes for Joint Operating Areas and contiguous fields need to be considered by the jurisdictions concerned. There can be a situation where a single field falls in two jurisdictions, which are exploited by a single operator, or two or more operators exploit contiguous offshore fields that fall within two separate jurisdictions, but share facilities. There is a need to design a holistic decommissioning regime wherever possible within the auspices of the joint operating agreement (JOA)/ joint development area (JDA) authority where applicable, or by consultation between the parties, in line with the recommendations of this chapter, and then proceed to estimation of plans and costs. The partner jurisdictions should then consider a consultation between their tax authorities to deal with the tax consequences that arise for the costs that are allocable to their jurisdiction.

## **H.5 Tax treatment of contractors undertaking decommissioning work**

The overall tax treatment of contractors performing decommissioning work should be on the same basis as those providing any other form of technical services in the country. The extension of deemed permanent establishment (PE) treatment to offshore projects under decommissioning should resolve any issues regarding work done on offshore platforms. Such subcontractors should be subject to the normal regime for withholding taxes and value-added tax (VAT).





## Chapter 7

### THE GOVERNMENT'S FISCAL TAKE

#### Executive summary

A government's share from the development of its natural resources can include many components whose nature and scope can be wide ranging. While likely to include income taxes and royalties normally associated with the extractive industries the government's share can also include other taxes and fees, as well as obligations placed upon investors, such as making infrastructure investment, employing and/or training residents, purchasing services and supplies from local businesses, and contributions to decommissioning and environmental costs. It is this total contribution to a developing country's economy that should be considered in evaluating fiscal take.

Both government and business objectives should be clear—and clearly communicated—in order to create a framework to design and apply a sustainable total contribution and tax policy. The government should form an idea of its potential resource revenues, what kind of return it expects, how it wants to receive its resource value as well as the timing of the expected return, and how it wants to manage and use the funds generated by its resources. Businesses should provide a clear description of the risks they perceive as investors, and an overall description of what they believe is necessary to make the investments required to achieve the sound and successful development of the natural resources at issue. Key elements in this assessment for both the government and potential investors are the fiscal instruments a government ultimately applies.

Great variation in the types and design of such fiscal instruments exists and each one has differing implications for both governments and investors. Fiscal policy for the extractive industries often consists of a combination of such instruments, and given the long-term nature and scope of these projects, long-term government objectives should drive the choice of instruments. Ideally, governments and investors should work together in such a way that the ultimate government take regime adopted promotes the government's objectives while

attracting the investment required for developing the country's natural resources.

Implementation issues for any particular fiscal regime (including monitoring, auditing and revenue collection) should also be considered at an early stage. Fiscal policy, no matter how well designed, will fail to sustainably attract investment if implemented poorly. It is therefore crucial to have upfront and ongoing coordination between the various governmental departments relevant to the government take, and perhaps even dependent on those funds. Consideration should be given upfront to allocation of profits/ tax revenues between parts of the national government and between various subnational entities in order to ensure that long-term investments in natural resources are sustainable for all the parties involved in the administration and execution of the venture.

## **Purpose**

The purpose of this chapter is to provide context for stakeholders as to how value derived from the development of a country's natural resources can be shared between the government and investors and to elaborate on what building blocks are available to allocate that value. Besides an overview of the types of government take available, the chapter elaborates on how various fiscal instruments can influence investment and revenue. The chapter provides additional information from that in other chapters on the building blocks of government take and basic fiscal instruments, focusing on how these instruments interact with each other and, more importantly, with the existing general tax regime in a country, including its international aspects.

This chapter is intended to assist policymakers and members of the tax administration of developing countries in participating effectively in extractive industries tax policy development and tax implementation as well as to provide information to other stakeholders. It should allow policymakers and tax administrators to understand implications of the choices they make when formulating tax policy and when applying existing legislation. Since fiscal policy and decisions around government take are at times made outside the Ministry of Finance (e.g., by a Ministry of Mines and Energy) the chapter underscores the importance of tax authorities' participation with their

counterparts in other departments in ensuring government take decisions can be applied consistently and in alignment with the existing constitutional and fiscal framework.

This chapter provides a broader context for viewing the overall issue of natural resource taxation and relates to other chapters, such as those on taxation of Indirect Transfer of Assets (Chapter 4), Value Added Tax (Chapter 9), and the Tax Treatment of Decommissioning (Chapter 6). Those chapters give more detail on these issues.

## **Background**

Developing a country's natural resources can provide a significant boost to economic development for a country. Planned well, and implemented with care, natural resource development can provide revenues and other economic benefits to a country and its citizens. Special considerations are required when a country decides to develop its natural resources since such resources are finite; the country would thus generally focus on obtaining the maximum benefit from the "one-time" extraction of such natural resources. From an investor standpoint, extractive industries investment also has special considerations as compared to regular investments: while the resources are finite, their extraction and development are risky and very capital intensive, with large investment required at the front end of the project life and a long lead time until profitability is achieved. On top of that, the business will require specific expertise for extraction and development.

Countries embarking on natural resource development will seek to find a balance between achieving a maximum benefit for the country in a responsible and sustainable way, while providing investors with a return on their investments commensurate with the risks taken. Resource holders should set up clear rules on how to secure an appropriate government share from these finite resources and while it is difficult to provide guidance that applies equally in all circumstances, there are general considerations that are relevant when designing and implementing extractive fiscal systems around the world.

## **Risk/return**

One of the most important considerations is how various risks involved in natural resource development are allocated between the resource

holder and the investing company. Risks include many items — geological, political and development risks — that influence the ongoing operating costs and the inherent and high risk in the pricing (or value) of the revenue stream over long periods of time. Commodity prices influence the return for the resource holder and investor, the cost recovery for the investing company and the ultimate price of the final product.

Activities related to the extractive industries typically carry higher levels of risk than for other business sectors. For example, the typical success rates for an oil and gas greenfield<sup>245</sup> exploration activity globally vary from one in three, to one in four. This is fundamentally a risky, capital-intensive business that can take decades to provide an economic return to an investor. The presence of fiscal stability affects the risk/return balance. Some of the risks can be influenced by the resource holder or the investing company, while some risks will be beyond the control of either party.

Investors generally bear the risks of providing the funding and technical expertise for the exploration and development of a natural resource project. Overall, they are comfortable with bearing the risks associated with the geology, development, overall project costs and commodity prices. They are less comfortable — and seek ways to reduce or minimize — political risks, including changes in fiscal terms. But they evaluate whether to invest on the basis of the full level of risks involved at the time they make their investments compared to the level of economic return that they can expect. The fiscal terms and overall government take will be a very important part of this evaluation.

The risk/return ratio can change over the life cycle of the development of resources. The return required to induce initial investors that were prepared to take on the “higher risk/ higher return” activity may be quite different from what may be required at later stages in the development of a country’s natural resources. It can be influenced by the accuracy of the seismic information or sampling of the underground and its analysis, but also by the price at which the resource is being traded internationally, the scarcity of the resource, the existing

---

<sup>245</sup> Greenfield exploration implies no previous exploration and production activities have taken place in an area. Only theoretical information is available about the underground and quality of the resources to be extracted. In case of pre-existing drilling, one speaks of “brown field”.

technology used to extract the resource and other factors. Countries should, as a policy, consider whether they would be willing to provide a better treatment towards investors who were, from the start, ready to undertake a “high risk/high return activity” as a way to attract that form of investment. These considerations will be influenced by the type of natural resource the country has within its territory, the historic risk associated in removing that resource from the soil, the location of the resources as well as other factors.

### **No “one size fits all”**

The interaction between costs and fiscal terms is critical in the design of the fiscal system. Terms that are sensitive to the cost intensity of the resource being developed and extracted will be the most effective. For example, in the oil and gas industry, the adage “cheap oil and tough terms come together” has been well demonstrated by resource-holding countries around the world that typically command a high level of government take for low cost/low risk developments onshore. The opposite is also true; high cost/high-risk exploration (e.g. in frontier deep water acreage) typically requires higher levels of investor return potential to incentivize companies to take on these higher risks.

Different perspectives on the geological attractiveness of the acreage, the long-term commodity price outlook, risk appetite, and internal profitability screening criteria often lead to a range of bids from interested companies. These risks and criteria are not assessed in the same way by all actors. Host countries may be more risk averse than potential investors. In the oil and gas industry, for example, national oil companies will very often have drivers and internal criteria that are different from international oil companies’ standards for determining economic return.

Throughout the life cycle of a project, the host government may want to increase jobs or develop domestic competencies. Developing countries may consider local content or other infrastructure requirements placed on investors to meet these objectives, and may adopt that approach in lieu of an increased fiscal take. Whichever way the objective is achieved, specific requirements will generally change the overall cost and risk profile of the venture for an investor, and as a result, will impact the fiscal terms.

Finally, as access to conventional oil and gas opportunities has declined, investing companies and investor countries have become more prone to pursuing unconventional opportunities, such as shale gas and oil sands development. These tend to involve a greater degree of difficulty in removing the resource, to be more expensive, or both. Unconventional oil and gas projects may require an adjustment of existing terms on offer: for example, the risk/return ratio may be different from conventional oil and gas opportunities; the cost structure, impact on environment and even the timing required to generate profit may be different.

### **Predictability**

In contrast to technical subsurface risks or commodity price uncertainties, for example, investing companies are uncomfortable about shouldering fiscal uncertainty. Risks associated with an unstable fiscal or tax environment impact an investor's overall risk profile and the return levels required. Investors view fiscal uncertainty as a risk that host countries can control; by doing so, host countries create a win-win outcome. The more a government can reduce investor risks, the higher the amount the investor will be willing to pay in terms of government take.

All things being equal, stability and predictability in a fiscal regime positively influence the risk/return ratio by creating certainty, which is more likely to attract investment. This is true throughout the project life, even late in the life of a basin or licence where the size of discoveries usually becomes smaller and smaller and the cost of abandonment and decommissioning comes into consideration.<sup>246</sup> Developing ever-smaller discoveries may increase risk to the point where there is no longer an acceptable chance of making an economic return, especially if there is the risk of further adverse fiscal change. Often fiscal regimes are stabilized in the contract to ensure predictability.

The ideal is to anticipate as many scenarios as possible (e.g., high and low prices, drilling and development cost changes, recoverable

---

<sup>246</sup> As detailed in Chapter 6 (The Tax Treatment of Decommissioning), the incidence and fiscal treatment of decommissioning costs should best be considered upfront. The focus on these costs and their treatment will become more prevalent later in the development as their Net Present Value increases.

reserve levels, etc.) and develop flexible fiscal terms to deal with such possibilities from the start. These can ideally address a variety of technical risks and different types of opportunities as well (e.g., onshore, deep water and unconventional oil and gas developments). To illustrate, Russia considered a tax system that proposes different terms depending on the type of opportunity (onshore, shallow offshore, deep water, arctic). This deals with uncertainty by providing flexibility in a predictable manner.

If this flexibility cannot be established at the onset, investors will value (and see less risk in) changes introduced by modifying the terms of the successive licencing rounds, if available, or via a mutual renegotiation process rather than through unilateral modification of the fiscal terms. While there may be merit in competitively tendering exploration acreage, there may be other situations where it is not in the best interest of the government to follow this approach, e.g., where licences are due to expire and it is mutually advantageous to enter into negotiations to extend the licence. See also Chapter 6 (The Tax Treatment of Decommissioning).

Predictability is also enhanced through simplicity of terms, which is an important driver and may need to be balanced with the other considerations. Especially when considering administrative implementation, the terms should be clear and simple enough to be administered with the human and financial resources and capacity at hand.

### **Long-term perspective**

Many oil and gas fields have a life cycle from exploration to abandonment of 30 to 40 years or more. The life cycle of mining activities can be even longer. Fiscal certainty over a long time span is therefore critical in investment decision-making, but will be challenging in view of what may be shorter political horizons.

In the taxation of EI, it is important to look at profitability over the life cycle of projects, which underscores the benefit of developing a fiscal terms structure that is flexible and works appropriately in periods of both high and low prices, costs, etc. It is also important to focus on the overall government take, rather than comparing individual elements of a tax and fiscal regime structure. Especially in developing countries, government take almost always includes indirect charges

such as investments based on infrastructure, employment, training, and local content requirements.

Integrating environmental considerations in fiscal system design is also important and is often not effectively addressed since environmental considerations may be dealt with by another part of government. Policymakers should consider including a framework to deal with those issues and obligations upfront, even if environmental requirements such as decommissioning are expected to come in only at the end of the project's life cycle. See also Chapter 6 (the Tax Treatment of Decommissioning)

### **Simplicity and clarity**

There are a number of ways to structure and design implementation and administration of the regime. Favouring simplicity in design and ensuring flexibility in the system while avoiding multi-tiered and complex “creaming mechanisms” (which allow for the proportion of government revenue to increase if certain aspects of the extraction or relevant financials improve) are two of those features. “Simplicity” should be the guiding principle, not in the least to ensure effective and efficient enforcement.

Efficient, predictable and stable tax regimes that are simple enough to be applied effectively and consistently, can incentivize long-term investment as well as reduce disputes. Developing a predictable and risk-based approach to deal with potential disputes and deal with compliance could help increase clarity while using government resources as efficiently as possible.

### **Scope**

To assist tax authorities in developing countries to contribute to the design of extractive industries fiscal systems and to administer such systems in an effective manner, this chapter:

- Elaborates on framework considerations both the resource holder and the investor may have when developing and evaluating the fiscal terms;
- Describes the most typical fiscal instruments used in the extractives industries;



- Lists potential consequences of the interaction between the various instruments as well as with the regular tax regime; and
- Considers some specific issues regarding tax administration and their impact on the effectiveness of a fiscal system.

This chapter does not deal with the determination of what an appropriate risk/return and fiscal share allocation should be. This will vary from country to country and even from project to project within a country. More importantly, the share of natural resource value that a resource holder receives from resource development is larger than the pure fiscal take. Therefore, the mandate to determine the appropriate return as well as the expertise to determine it will generally be beyond the tax administration's mandate and jurisdiction. The content of the chapter should however allow the relevant tax authorities to challenge assumptions made regarding fiscal take determinations and contribute to the design of fiscal terms to ensure policymakers include tax-specific considerations and interactions when defining the contractual arrangement for exploration of resources and negotiations of terms for an agreement.<sup>247</sup>

### **Stakeholder considerations**

The overall framework determining government take will do more than allocate extractive industries revenues between the resource holder and the investor. The choice of specific extractive industries-related instruments, or combinations thereof, is likely to have an impact on the business a country seeks to both attract as an investor and tax, beyond that of creating a revenue-raising capability. This is more the case for extractive industry taxation than for general profit taxation, as general profit taxation is primarily set up to raise government revenue

---

<sup>247</sup>Economic modelling is very relevant and tax experts should be involved in the economic modelling done by a country on extractive industries fiscal take. They should be in a position to challenge what tax assumptions have been made for the modelling and whether the pre-existing fiscal rules have been considered in the overall economic modelling. Modelling support is available with the International Monetary Fund (IMF) (e.g. its FARI model) and various other institutions (e.g., Columbia University Centre on Sustainable Investment's economic modelling on gas, available at <http://ccsi.columbia.edu/work/projects/open-fiscal-models/>).

where an extractive industries fiscal regime allocates risks and returns of a venture.

There are extractive industries specific drivers that need to be considered in order to fully understand a government take regime and its potential consequences on government and investor behaviour. The more clarity various stakeholders have with respect to each other's drivers and objectives, the more they can be aligned, which in itself will improve the sustainability of the project.

### **Resource holder considerations**

***Overall fiscal take.*** A country's natural resources should contribute to the general development of an economy. The way the government take is set up and applied will directly affect the ability of a country to achieve those objectives and if and how investors engage in natural resource development projects. When assessing the level of government take that will come from developing the country's resources, resource holders and administrators should consider the total contribution this development could and should make and what the economic and social developments are that they wish to achieve with and through this contribution. This may include the development of new infrastructure, eventual transfer of infrastructure, the fulfilment of local content requirements, contribution to training funds and community projects, as well as tax, royalty and other revenues that arise as a result of the fiscal terms. Local content development is often very important for developing countries and can be achieved through regulations or contract requirements as well as through monetary contributions to government.

***Timing.*** The government holding resources is often faced with managing expectations from its citizens with respect to ongoing exploration activities, especially as they become successful. Due to the long-term nature of extractive projects, the timing of revenue generation needs to be carefully planned and managed. Governments can make use of different instruments in order to obtain the government share and many have different timing effects: some are more "front-loaded" than others, having an earlier "realization" date. Front-loading may be helpful in gaining revenues early and demonstrating to the country the benefits of resource development. Since front-loading generally negatively

impacts the risk/return assessment by investors, the balance in addressing a country's expectations on timing and the competitiveness of its regime is critical to a successful outcome.

**Funding concerns.** Fiscal terms can often include the government owning an equity stake in a project. If a country considers taking on an equity stake, how it will fund its obligations for exploration and development costs is a key question. Where high-risk exploration is involved, such as in areas without existing fields or mines, a country's willingness to accept this risk, in whole or in part, can introduce new challenges for governments. This decision will be influenced by their ability to bear risks and costs; for example, drilling exploration wells is very costly, and how to deal with public concerns and expectations in the case of unsuccessful results must be considered. Not all governments will have the funds or technical expertise to embark on such projects. The funding requirements for the host government will be even larger if an NOC participates in the venture. The NOC will have to finance its ventures, often with revenues only coming in much later in the life of the project. Even governments that do have the funds available may decide to rely on investors for funding such higher-risk projects and reserve their own funds for other important country objectives. Funding concerns will also come up at the end of the project, when funds need to be available to deal with decommissioning and/or restoration costs—a time when the revenues from the ventures are, at very least, in decline.

**Development objectives.** Resource-rich countries may seek to achieve very different objectives, and thus tailor fiscal terms quite differently, depending on the level of political, economic and natural resource development:

- In the early years of opening up acreage for exploration, a government may want to focus on incentivizing high-risk exploration activity (e.g., to “prove” that the acreage has oil and gas resources or to assess the grade of the minerals). Terms can be tailored accordingly to achieve this objective.
- Once the acreage has been “de-risked” and the geological play has been “proven,” the focus may switch to maximizing early revenues to the government (e.g., to fund social development programmes). Terms can be tailored to achieve this objective.

- In mature extractive industry provinces, governments may shift their focus to maximizing ultimate economic recovery from a basin, particularly if there are limited windows of opportunity from an infrastructure or resource perspective. For example, the reservoir pressure for oil and gas reserves tends to diminish towards the end of life in a basin. Effective production may require artificially increasing pressure, the costs of which may make a venture economically unattractive at a certain point. Again, terms can be tailored to meet this objective.

**Environmental impact.** Host countries are increasingly concerned about the potential impact of extractive industries on the environment and specific ecosystems. With extraction becoming technically possible in more remote areas—and in situations such as extreme deep water or unconventional resources requiring hydraulic fracturing technology—consideration will be given to how the risk of extraction to the environment will be managed and allocated. Applicable environmental taxes will be considered in determining the overall fiscal take, as will required contributions or reserves for decommissioning and/or restoration. Environmental conservation is often dealt with by different governmental organizations than those involved in fiscal take, however. In any case, environmental issues need to be considered upfront, to ensure appropriate decommissioning regulation and tax treatment.

**Competitiveness.** Upfront clarity on both the overall objectives as well as the future use of expected revenues is very relevant to assessing whether the resource holder can, should or wants to provide incentives to attract foreign direct investment in, or related to, the development of its extractives sector. Overall, countries that are perceived to have lower levels of risk (technical, political or economic) will be able to command higher levels of government take—that is, higher rent taxes or other fees and obligations. Countries perceived to have higher levels of risk will need to design their fiscal regimes to be more attractive to incentivize companies to put capital at risk. There are ways related to contract negotiation and renegotiation that can address the competitiveness issues.

**Internal allocation: funding subnational entities.** Projects and investments tend to be more sustainable if the overall sharing of

risks and benefits within a country (among various subnational entities) is clear; this is especially the case in larger countries or in cases where the extractives are centralized in certain areas of the country. Involving local communities at the negotiation stage should be considered to ensure their buy in. Such clarity is important for policymakers as well as investors. If the allocation of funds is not clear, this could have a negative impact on the stability of the terms agreed.

***Interaction with pre-existing legislation.*** The specific fiscal instruments for extractive industries will interact both among themselves and with the corporate and other tax systems that may be applicable in the national or subnational sphere of the country. This interaction is not always addressed in a timely or appropriate manner, due largely to the fact that the upstream fiscal instruments are often regulated by a government department (e.g., a Ministry of Mines and Energy) other than the one dealing with the general tax system (generally the Ministry of Finance or the Treasury Department). It will be important for a country to ensure close coordination among the affected governmental departments to ensure that whatever is negotiated or regulated by one Ministry is not inconsistent with laws and regulations that have to be administered by other governmental agencies.

## **Investor considerations**

***Risk/return.*** In the global competition for limited capital and human resources, investing companies will seek investment opportunities which offer the best risk/return balance. Attempts to introduce higher resource rent taxes after investment has been made can also lead to capital flight, which in turn may require counteracting measures (such as the introduction of incentives) to try to bring capital back.

Free-market fundamentals can be achieved through competitive bid rounds and through direct negotiations when the technical scope or economics of an area are difficult or require expertise that is limited. Considering the extractive industries life cycle, the terms required to promote investment in the early stages of exploration of a frontier resource may evolve for future licencing rounds, when activities becomes less risky. While governments may desire to improve their financial returns on such future activities, making changes retroactively to projects undertaken under higher risk conditions is likely to

be viewed negatively by investors and could well affect future investments in other higher risk areas within the country.

**Stability.** If companies perceive the need to manage the risk around an unstable tax and operating environment, this will impact the overall risk profile and therefore the underlying return. Investment decisions are impacted by the risk of adverse fiscal change, meaning the return required by an investor will increase if faced with an uncertain fiscal environment. That will result in much less attractive bids for governments as investors factor in potential future changes. Fiscal uncertainty can also adversely affect the transfer of properties and licences among different companies, which in turn can lead to less than optimal development of the resources.

**Competitiveness.** Many types of fiscal regime can work if they are competitive and predictable for investors. However, it is important to understand the allocation of risks and returns under the fiscal regime ultimately adopted by the country. While any fiscal system can be designed to give a level of economic return at a specific commodity price, how the underlying risk and return profile changes under different cost/revenue scenarios will determine the interest levels from investing companies. Often progressive systems are considered more competitive by investors as they move the timing of government share closer to the economic break-even point. As previously noted, more front-loaded systems (such as systems including signing bonuses or introducing ring-fencing per well) are generally considered less competitive by investors.

**Predictability.** Changes to the tax law in general will impact the return to investors. As noted above, investors place a high value on stability, and stability includes the consistent application and administration of tax rules and regulations. It is important that countries treasury and tax officials be aware of these considerations and engage with their counterparts in other governmental departments before making general changes to tax law. Attempts to introduce higher government take, such as increased rent taxes, after investment has been made can also lead to “resource flight”, which in turn may require the introduction of incentives to try to bring capital back.

Similarly, investors see a benefit when other departments engage with the treasury and tax authorities before finalizing fiscal take. Often,

the interaction between fiscal terms and general taxation comes to a head when actually applying the fiscal regulations — for example, at the moment of filing returns, tax assessment or tax collection — and this can be too late if there is any ambiguity or misunderstanding between governmental agencies regarding the interpretation and application of fiscal terms. Resolving such ambiguities or misunderstandings at the negotiation stage (or at the time fiscal terms are developed and statutorily approved) reduces investor risk and benefits to both the investor and the country. Also, for the country itself, a particular fiscal policy will not yield the desired results in government revenues if ambiguities and inconsistencies exist and the responsible government department is not in a position to consistently and predictably assess and collect revenues.

***Ownership of underlying reserves.*** One of the performance metrics relevant to international oil and gas companies is the Reserves Replacement Ratio (RRR). The RRR indicates to what extent companies are able to find and “book” hydrocarbon reserves to replace the amounts produced each year. A company would have an RRR of 100 per cent if for every barrel of hydrocarbon produced another barrel is found/discovered and booked. The required ownership interests in the reserves needed to “book” such reserves will be determined by the contractual arrangements. Generally, concessionary systems and contract systems contribute to RRR, but acreage covered by service contracts will not.

### **Building blocks for government share**

A whole range of extractive industries-specific instruments are available to allow resource-rich countries to allocate the revenue from their natural resource wealth and to tax the extractives industries sector.<sup>248</sup>

---

<sup>248</sup> Sources that describe extractive industry fiscal instruments are included in the “For more information” section at the end of this Chapter. Specifically, a number of basic works are recommended for further reading on this subject: Philip Daniel and Michael Keen (Eds.), *International Taxation and the Extractive Industries* (New York: Routledge, 2016); International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation*, (2012) available from <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>; Silvana Tordo, *Fiscal Systems for Hydrocarbons: Design Issues*, World Bank Working Paper No. 123, (Washington, D.C.: World Bank,

The share a government will receive or retain regarding development and production of its natural resources can take many shapes and forms. As noted, overall government take is certainly not limited to the taxation of the revenues generated by the extractive industries, but can also include the following:

- Signature bonuses, to be paid, often in cash, at the moment the contract is granted to a specific area;
- Part of the production, which can be obtained directly by the host country in various ways:
  - Through state participation in the venture in which case the host country will obtain a certain part of the production in accordance with its participation; the country will generally have to contribute its share of the costs as well;
    - In cases where the host country is not required to fund its part of the costs, it can be “carried” by the investors, who then may receive an additional share of the production until repaid; the host country does however participate in sharing remaining revenue, and may use that for future costs;
  - Through a production sharing contract, where a fixed share of production is reserved for the government;
- Production-based contributions like royalties, often determined based on volume or price of the commodity;
- Various forms of taxation on the corporate result, taxing either the profit or the cash flow generated, such as corporate taxation, hydrocarbon taxation, resource rent taxation;
- Indirect taxation such as value added tax (VAT) as well as customs, other import or export related taxation, environmental taxation;
- Required investment in training, infrastructure (such as

---

2007); Carol Nakhle, “Petroleum fiscal regimes: evolution and challenges,” in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*, ed. Philip Daniel, Michael Keen and Charles McPherson (Routledge: New York, 2010) p. 89; Lindsay Hogan and Brenton Goldsworthy, “International Mineral Taxation: experience and issues”, also in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*, p. 122.



production or transport facilities) and local social or educational facilities; stipulations are often included that transfer ownership of these facilities to the national or local government at some point; and

- Other contributions.

There are various aspects to determining a government's share: Who owns the resources throughout the development? Who is responsible for the costs? Who is entitled to the revenue? Who makes the decisions? The eventual tax take will be influenced by different allocations of risks and revenues and by the resulting rules that are not always drafted for and by tax officials.

Determining who owns the resources and the revenues is largely governed by the local legal framework, statutory rules, or contractual arrangements between the resource owner and the entity exploring and developing the resources. Therefore, understanding these arrangements is critically important to understanding a government's fiscal take risk/return.

### **Contractual arrangements**

The resource holder sets the legal framework within which to work or agree with the investor. Sometimes the details of the legal arrangements are set by law or even by the country's Constitution; sometimes only the framework is set. In certain countries, the terms are negotiated and set contractually.

Regardless of the legal instrument involved, there are basically three different types of natural resource arrangements: concessionary systems, production sharing contracts and service contracts.

The different systems tend to differ in the level of risk and ownership that is granted to the investor, with the concessionary systems generally transferring most away from the resource holder and service contracts transferring least.

As noted, any fiscal system can be designed to give a level of economic return at a specific commodity price, but how the underlying risk and reward profile changes under different cost/revenue scenarios will determine the government share as well as the interest levels from investing companies.

## Concessionary systems

A concession is an agreement regarding a fixed area where government grants a company the exclusive right to explore for, develop and produce resources at its own risk and expense, generally for a specific amount of time. The company is entitled to ownership of the resources it produces from the concession when extracted at the wellhead (or at another agreed point of transfer of title).

A concession is sometimes called an exploration licence or production lease. These systems apply to both the oil and gas, and the mining sectors. In the mining sector, such concessionary systems are generally implemented by way of leases that cover a specific area for underground or surface mining.

Unlike contractual systems, where the production allocation under the contract itself is part of the fiscal take, the concession agreement itself contains few specific fiscal features. The production of natural resources under a concession system is itself generally subject to a variety of other fiscal instruments. Commonly, the concession holder will be taxed on the profits generated, often under the general corporate income tax regime. In addition, the concession holder is likely to be required to compensate the resource holder (country) for the resources extracted in the form of an oil and gas or mineral royalty. Concession systems are therefore often referred to as tax/royalty systems. It is not uncommon for resource holders to add elements of government take on top of the regular corporate income tax and royalty. For example, many countries impose an additional profits tax on top of, or separate from, the regular income tax.

## Contracts

Various types of contract systems are possible. Under the more typical ones, a company is designated as a contractor in a certain area. The title to the resources (in this case, generally oil and gas) will remain with the State and the resources produced will belong to the government until and to the extent it is explicitly shared under the contract terms. The company operates in accordance with the terms of the contract, at its own risk and expense under the control of government. The government agrees with the company that the company contract partner meets and finances the exploration and development costs in return for a share of production in kind or in cash.

Contract arrangements are generally called production sharing agreements (PSA) or, most commonly, production sharing contracts (PSCs). Besides specifying the terms and conditions under which production will occur, a PSC specifies the percentage of production each party will receive after the participating parties have recovered a specified amount of costs and expenses. They tend to be used only in the oil and gas sector. Often various international oil companies and national oil companies are partners under the same PSC, with one of the partners designated as the operator. Depending on the circumstances, it can be the party with the highest participation, or the party with the longest history or largest presence in the host country. The choice can also be determined by the specific expertise or technology one of the parties has and it can be a different party for the various stages of the contract. The operator is not considered a subcontractor and is entitled only to reimbursement of its costs (without any markup) and which are shared as such between the agreed partners.

In the oil and gas industry, PSCs are used in cases where the parties agree to share the production and related costs of the oil and gas produced. A PSC will be specific about how the contract partners share the production and uses specific terminology to describe how they “split the barrel” of oil. The split can be done in cash or in kind. To understand the fiscal take under a PSC, it is important to understand certain terminology:

- The barrel will first and foremost contain cost oil. Costs that can be recovered can be exhaustively listed or generally indicated in the PSC and typically include exploration costs like seismic tests, drilling of wells, or sample analysis, production costs of production facilities and infrastructure investments, plus other technical and administrative services. The costs that are allowed to be recovered as “cost oil” under the PSC are often similar but may differ from costs acceptable for accounting purposes or corporate income tax.
- The amount of costs recoverable is sometimes limited to an amount called the “cost stop”. The company is entitled to recover only the amount of costs up to the limit of the cost stop. If the costs exceed the cost stop the contract is defined as saturated and the excess costs will not be recoverable (at least during that period of operations). The cost stop guarantees a

part of the production to the government (as long as the value of the crude produced is higher than the cost stop) and can be especially important during the first (and potentially last) years of production when the costs are higher. The cost stop can be a fixed amount but, in most cases, it is a percentage of the costs of the crude oil. If a cost stop is in place, it is often important to specify what that will mean to the determination of the taxable result under the applicable income tax. There is often disagreement as to whether the cost stop also means some costs are non-deductible or can be carried forward or back for income tax purposes, making certain costs potentially non-recoverable under both the production sharing formula and the corporate income tax.

- When the costs incurred are less than the cost stop, the difference between the costs and the cost stop is called excess oil. Usually, but not necessarily, the excess oil is shared between the government and the company according to the same rules applied to the profit oil (see below). Again, it is important to specify what this means for the determination of the taxable base.
- Profit oil after allocation is generally the portion of production that will constitute the basis on which to apply profit taxes under the PSA. It is important to determine how much of the costs will be deducted from the profit oil and how the countries' tax rules will apply to the taxable profit oil allocation.
- Certain contracts refer to "tax oil". In case the contract is a "tax paid PSC," the government partner, generally a national oil company, pays the income tax for and on behalf of the investors. In this case, there is no explicit tax oil as the tax would be paid out of the host government's share of the profit oil. In effect, a tax paid PSC provides greater stability to the investor on its income tax as any changes in the tax rules would affect only the allocation of the government's share into profit and tax oil. Tax paid PSCs act like stability clauses. They can be set up on a simple basis, where the income tax is calculated normally on the profit oil. Alternatively, they can be set up on a gross-up basis.

Unlike the concessionary systems, various aspects of a PSC give rise to government take or impact the eventual tax burden. Part of the government take will come from the production sharing, with the cost

reimbursement— as defined in the cost oil terms under the PSC— also being an important part of the calculation. Any ring-fencing, cost stop or other restrictions on cost compensation will increase the government take and influence the risk/return balance. The profit oil— which generally is represented by the profit but is increased by any restrictions on cost compensation— will then be subject to income tax rules. Any income tax due constitutes an additional part of the government take. The determination of the taxable profit may, however, be different under general tax rules compared to the PSC determination of costs and profit oil. Clarity needs to be provided on how the various rules interact and it is highly recommended to include these clarifications in the PSC, the income tax code or both.

In the mining sector, agreements on production sharing tend to include

- Lease rental payments; and
- Hard minerals distributed in kind in lieu of royalty payments or dividends.

### **Service contracts**

Service contracts are sometimes referred to as “technical assistance contracts” or “technical service agreements” because they are generally contracted regarding existing fields. Service contracts tend to be typical for countries where the country only seeks to attract additional expertise. The contractor tends to hold less risk in these situations and provides its services for a fee. In some cases, the contractor may be exposed to cost overruns as compared to approved budgets, and thus sometimes these arrangements are referred to as risk service contracts. As the marginal costs are more relevant in these types of contracts, cost and timing estimates as well as fiscal terms are critical. Very often it is a State company or NOC that manages the actual resources and contracts with the service provider. The service provider has no right to the underlying resources.

In the mining sector, the lease holders may choose to mine the leased area themselves (known as owner mining) or subcontract the mining operations to a subcontractor based on clear production and cost criteria (known as contract mining). In addition, service providers (generally known as mine support service companies) may be

awarded contracts to perform specific services (such as drilling, blasting or hiring of a mining fleet).

The service provider is generally subject to the regular corporate income tax system, potentially at an increased tax rate. In addition, certain fiscal instruments will be added.

### Fiscal instruments

A multitude of fiscal instruments<sup>249</sup> exists that can generate revenue for the resource-holding country.

Table VII.1

#### Revenue-generating instruments for resource-holding countries

| Mechanism        | Description                                                                                   | Prevalence | Number of countries<br>Mining<br>Petroleum |
|------------------|-----------------------------------------------------------------------------------------------|------------|--------------------------------------------|
| Signature bonus  | Up-front payment for acquiring exploration rights                                             | 1          | 16                                         |
|                  | Commonly used as a bid parameter (Notably for petroleum in the US offshore continental shelf) |            |                                            |
| Production Bonus | Fixed payment on achieving certain cumulative production or production rate                   | None       | 10                                         |
| Royalties        | Specific (amount per unit of volume produced)                                                 | 2          | 1                                          |
|                  | Ad-valorem (percentage of product value)                                                      | 17         | 31                                         |
|                  | Ad-valorem progressive with price                                                             | 1          | 9                                          |
|                  | Ad-valorem progressive with production                                                        |            | 8                                          |

<sup>249</sup>International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012). Available from <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>, p 22.

Table VII.1 (cont'd)

| Mechanism                           | Description                                                                                                    | Prevalence | Number of countries<br>Mining<br>Petroleum |
|-------------------------------------|----------------------------------------------------------------------------------------------------------------|------------|--------------------------------------------|
|                                     | Ad-valorem progressive with operating ratio/profit                                                             | 3          | 1                                          |
|                                     | Royalty applied to operating margin (net profits royalty)                                                      | 2          | 0                                          |
| State, provincial, and/or local CIT | Rate of corporate income tax at the state, provincial, or local level in addition to federal level             | 2          | 5                                          |
|                                     | Common in Canada and the U.S. as a province/state resource charge in addition to federally imposed CIT         |            |                                            |
| Variable income tax                 | CIT where the tax rates increase with the ratio of taxable income to revenue, between an upper and lower bound | 3          | None                                       |
| Resource rent taxes                 | Cash flow with accumulation rate/uplift. Can be assessed before or after CIT                                   | 5          | 5                                          |
|                                     | Cash flow with limited uplift on losses (UK) (surcharge tax on cash flow)                                      | None       | 2                                          |
|                                     | Allowance for Corporate Capital                                                                                | None       | 1                                          |
|                                     | Allowance for Corporate Equity                                                                                 | None       | 1                                          |
| Other additional income taxes       | Other profit taxation mechanisms that do not fall under any of the categories above                            | 1          | 3                                          |
| Production sharing                  | Fixed production share                                                                                         | None       | 5                                          |
|                                     | Cumulative production                                                                                          | None       | None                                       |

Table VII.1 (cont'd)

| Mechanism                             | Description                                                                                         | Prevalence | Number of countries<br>Mining<br>Petroleum |
|---------------------------------------|-----------------------------------------------------------------------------------------------------|------------|--------------------------------------------|
|                                       | R-Factor: ratio of cumulative revenues to cumulative costs                                          | None       | 13                                         |
|                                       | Rate of return, pre- or post-tax                                                                    | None       | 3                                          |
|                                       | Production Level                                                                                    | None       | 13                                         |
| State participation                   | Free equity: government receives percentage of dividends without payment of any costs               | 2          | None                                       |
|                                       | Carried equity: government contributions met by investor and recovered from dividends with interest | 3          | 8                                          |
|                                       | Paid equity: government pays its share of costs                                                     | None       | 19                                         |
| Social investments/<br>infrastructure | Resource companies build infrastructure or make other social investments (hospitals, schools, etc.) | 1          | 6                                          |

Some of the revenue sources are profit related, others volume related, and they can be specifically applied to the extractive industries or to certain types of extractives. Alternatively, the extractive industries can be subject to the general taxation rules of the country. There is an increasing variety of fiscal instruments and they are often used in combination. The indirect taxation of the extractive industries also forms part of the fiscal take.<sup>250</sup>

<sup>250</sup> Specific value added tax (VAT) issues are elaborated on in Chapter 9 (Value Added Tax). Oil and gas tend to be excisable products, therefore customs and excises are relevant. As explained in Chapter 9, it is important to point out that where a country largely exports its natural resource production, VAT should not be viewed as a viable source of country revenues and fiscal take, since VAT is rebated on exports.



## Profit-based fiscal instruments

Profit-based fiscal instruments include:

- **Corporate profits tax**, which applies to mining as well as oil and gas activities, can be a flat tax rate on profit or a variable rate to capture more revenues when profits are above a given threshold (generally called an R factor). The corporate tax applied can be the corporate profit tax generally applicable to all businesses, either at the same rate or a special rate. For example, Italy and the United Kingdom apply a supplementary tax for oil and gas; the corporate tax base of oil and gas companies is subject to an additional percentage of profits tax. It can also be a specific corporate profits tax applicable only to extractive industries;
- **Special petroleum/hydrocarbon tax**, which is strictly for oil and gas, is often based on a country's corporate profit tax but with special features that can significantly deviate from the general regime. Whereas the general corporate profit tax on extractive industries is generally covered under double tax treaties, special petroleum taxation is sometimes not covered. This can impact investors differently, depending on their home country tax regimes and is important for a developing country to consider (see Chapter 2 on Tax Treaty Issues).
- **Resource rent taxation**, which can be applied to mining as well as oil and gas, is generally a profit-related tax, but is not calculated on the basis of normal corporate profits. It is usually based on gross revenue from the resource development, and allows for certain allowances or deductions. Often, interest costs are not considered deductible and restrictions are in place for cost deductions regarding overhead services. It shares similar features with hydrocarbon taxation;
- **Windfall profits tax**, also referred to as excess profits tax or a cash flow tax, can be profit related. A windfall profits tax imposes a higher tax rate on profits or gains realized from a sudden windfall of a particular company or industry. Often the windfall or the increase in rate to deal with the windfall is not directly profit related but is linked to commodity price hikes, which are generally viewed as triggering disproportionate increases in profits;

- **Tax on mining revenue**, which is a tax triggered once the project has reached a predefined rate of return and beyond which it generates an extraordinary profit or revenue. The revenue is a kind of “abnormal” profit linked with the scarcity of the resource. In practice, the revenue is calculated as the total cash receipts in excess of the cumulative costs that are increased by a rate of return required by the investor. The mining revenue—or economic revenue—is the difference between the gains generated by the mining activity and the expenses; these gains include a “regular” return on capital. In theory, the surplus can be taxed at 100 per cent without affecting the exploitation of the resource. That is, without affecting the choice of the investor and without economic distortions, mining (or economic) revenue is a source of revenue collection of particular interest to governments. The return level on the capital invested, however, needs to take into account the full level of risks of the investor at the time the investments are made. The calculation is done by raising the annual losses of the rate of return required by the investor (“uplift”) and by adding them up to a level at which the losses are recovered. (In accordance with what has been developed initially in the economic literature, the uplift is fixed in a way to give the investor a minimum required rate of return, but this choice is now disputed.) Everything that goes beyond these plus costs is the revenue that can be taxed at a rate to be determined. Australia uses this mechanism for mining activities of coal and iron. It is also planned to be implemented in Sierra Leone with a deduction of the corporate tax paid from the taxable base. It is generally applied with a tax barrier (ring-fence) by licence.
- **An additional tax on cash flow** is available as a revenue source. The taxable base is the positive cash flow of the project, once the investment is recovered and by including the costs of the corporate tax. The profit is adjusted annually by adding the depreciation and the interest, by deducting any expense in capital. This can also be the base of a plus tax. Instead of allowing a supplementary provision in respect of losses carried forward, as is done in the case of the tax on mining revenue, a simple provision (or uplift) can be added for the investor to recover the expenses on capital at the beginning of the project. This is

done in the United Kingdom through an additional allowance of losses limited in time.

Special features of profit-based taxation:

- **Depreciation rates** These are rates for capital expenditure deduction that provide an optimal level for both tax revenue and investment. For instance, assets that require high capital expenditure may have a high depreciation rate to encourage investment. In both mining and oil and gas taxation, accelerated depreciation is often available, sometimes limited or focused on the early years of production. Increased depreciation rates generally support asset investment.
- **Uplift** Unlike accelerated depreciation, where depreciation rates are increased but the amount of depreciation in total is limited to the investment costs (i.e., the depreciation base) an uplift actually increases the depreciation base. To illustrate, one approach is: for every dollar of investment, an uplift of 25 per cent is permitted, such that depreciation on \$1.25 is allowed. For example, both Denmark and Norway apply an uplift in their hydrocarbon taxation. Uplifts have been used effectively by both countries to keep the asset investment pipeline filled despite being mature oil and gas provinces.
- **Ring-fencing** It occurs when certain costs or revenues are considered separate from other costs and revenues, creating separate bases for taxation within a single taxable entity. The ring-fencing can occur per type of activity. For example, in the United Kingdom, the upstream taxable base is ring-fenced and subjected to a higher rate compared to other business activities. The ring-fence can go into further detail (e.g., requiring a taxable base be determined per mine or per field). Ring-fencing will bring forward the timing of realization of government take for the government. It may give rise to tax payments before an overall venture is profitable. In case certain mines or fields never become profitable, ring-fencing will actually create sunk costs—costs that will never be recovered by the investor in the host country, although the investor may be making tax payments on other mines or fields in the country. Such systems can delay capital investments and improvements.

## Production-related taxation

The main example of production-related taxation or government take is the royalty. Royalties are paid by the holder of the right to extract natural resources to the resource holder to compensate for natural resources that are extracted. Royalties are generally determined: (i) on gross production; (ii) based on either volume or value of the extracted commodities; and (iii) at a certain rate, which can be fixed or at a sliding scale.

A second form of taxation comes in the form of severance taxes. In jurisdictions where most extraction occurs on privately owned land or where subsurface minerals are privately owned (for example, the United States of America) the main production-related taxes are called severance taxes.<sup>251</sup> Severance taxes are defined as volume or value-related payments due when non-renewable natural resources are extracted (or severed) within a taxing jurisdiction. Resources that typically incur severance taxes when extracted are oil, natural gas, coal, uranium and timber. Some jurisdictions use other terms such as a “gross production tax”. Where the resources are publicly owned to begin with (for example, in most Commonwealth and European Union countries) a resource royalty is paid instead of a tax.

## Specific arrangements

Other arrangements often used to tax extractive industries or to provide resource holders with additional revenues or other economic value include:

- State participation (mainly for oil and gas);
- Bonus payments (often related to the signature of the contract or the transfer of the lease);
- Carry (mainly for oil and gas and generally involving PSCs);
- Land rentals (mainly for mining); and
- Other non-revenue/cash-based systems, such as:

---

<sup>251</sup> Since royalties are generally paid to the resource owner, in the case of private ownership they are paid to the private owner(s). Severance taxes are imposed in addition to any private royalty payment obligations, and are paid to governmental bodies.

- Infrastructure requirements, including building roads, hospitals, schools, water projects, housing communities (e.g., in Ghana, one investor has committed to building a 15km road, taking this responsibility over from Government);
- Infrastructure transfer/intellectual property transfers;
- Training levy/support for study costs; and
- Sponsorship of specialist courses at universities.

State participation can be another effective route to ensuring governments secure an appropriate share of the upside in times of high prices or lower costs, while maintaining progressivity. Government equity ownership essentially places the government, or a government-owned entity, in the position of a partner in the joint venture, along with the operator and any other investor partners involved. This participation can align investor and government interests, providing project advantages such as risk sharing, development ownership, and ensured support for development. Participating partners are, however, expected to share equally in the costs of the venture; thus, the government will have to consider how to fund this. State participation is far less common in mining than it is in oil and gas.

Bonus payments provide early, upfront revenues to countries, and thus have a timing appeal to governments, but are least favoured by investors, as they are upfront payments unrelated to actual production and thus are most regressive. Where bonus payments are involved, it will be important to consider which part of government receives the payment, how transparent the payment is and whether it goes to the national budget or to the budget of the administrative entity where actual exploration and extraction will take place. Bonus payments occur both in mining and in oil and gas.

A “carry” is a situation whereby a party pays for an agreed part of another party’s share of the cost in proportion to the participating interest in a jointly owned exploration licence/venture in the expectation of recovering those costs from a share of future production. As it generally relates to situations covered by PSCs, it is more often applicable in oil and gas ventures and it generally only applies during the exploration phase. The carry can apply towards another IOC as well as towards the government or NOC. To the extent that a carry is in place for state participation or involvement by the national NOC, a carry

can be part of the government take. In any case, it is important to be clear on the general tax treatment of costs paid under a carry for profit and potential capital gains taxation in case of subsequent alienation.

Some special extractive taxation consists of one-off levies targeting specific sectors. An example of one such special tax is the National reconstruction levy/National Fiscal Stabilization Levy (NFSL) in Ghana, where the levy was earmarked to finance a specific sector of the economy. In 2013, the Government of Ghana announced a number of tax initiatives passed by Parliament. The initiatives included reinstatement of the National Fiscal Stabilization Levy Act. Under the Act, a 5 per cent national fiscal stabilization levy was applied on profits before tax for specific companies and institutions operating in the country. The list included companies providing mining support services.

### **Indirect tax**

Indirect taxation is the taxation not of profits, but of certain transactions. Often, an indirect tax exists that can be specified for certain products or transactions; it is generally considered as part of the fiscal take, at least by the investor. Some examples are

- VAT, with a focus on EI-related issues and impact on government take/fiscal terms;<sup>252</sup>
- Import/export-related taxes, duties, or fees;
- Excise taxes for certain related products, such as mining imports of certain fuel or pre-cursor chemicals, which are key components in mining processes.

Special issues regarding indirect taxation for extractive industries are covered in Chapter 4 (Indirect Transfer of Assets).

### ***How to evaluate fiscal instruments***

To make the investment sustainable and guarantee the revenue flow to the resource holder, all stakeholders' interests should be balanced when managing the fiscal instruments applicable to the extractive venture. To do so, it is important to understand the effects of each of the typical instruments, including their impact on the timing of

---

<sup>252</sup> See Chapter 9 (Value Added Tax).

the revenue, on a country's overall policy objectives, and on the risk/return balance.

### **Timing of revenue**

Certain fiscal instruments focus on achieving government take from ventures early on, often regardless of whether the venture is generating profits or even revenue. These instruments move the moment of taxation or government take forward to a date before the venture achieves profitability. In these cases, the taxation of the venture is said to be “front-loaded”.

From a government point of view, some front-loading may be required to manage the expectations of the country or to ensure government funding can be achieved to ensure participation in the venture. Generally, front-loaded systems are more “regressive”—that is, they are less related to profit and effectively tax lower return ventures/production relatively more heavily than larger ventures—whereas progressive systems tend to be more profit related, taxing more profitable projects more than less profitable ones and generally delaying the timing of taxation until profits begin to be realized. (See below for further discussion of progressivity and regressivity in fiscal terms.)

From an investor point of view, front-loading negatively affects the risk/return balance which, depending on degree, can affect the project's competitiveness. Investors generally evaluate and compare projects on a discounted cash flow basis, thus the timing of investments or payments has a direct impact on the investor's perceived return from a project. From the investor's point of view, terms that defer cash pay-outs or accelerate the tax deductibility of costs will be favoured.

Signature bonuses generate revenue very early in the venture. They provide government take before any revenue or even production is generated from the venture. If equity elements (i.e., state participation rights) are reserved, depending on their size and funding, they also can impact the risk/return balance significantly. Equity rights generally do not require cash payments from investors (unlike, especially, the signature bonus), except when the equity rights of the government include a carry arrangement.

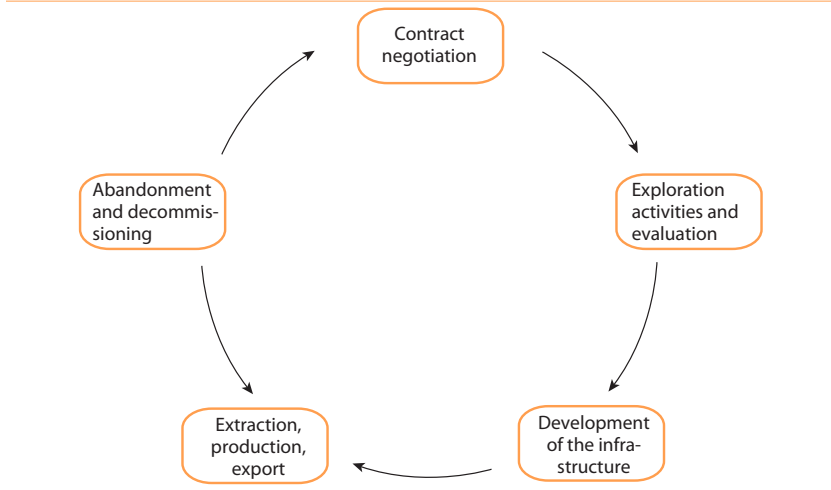
Royalty systems come into play once production starts but do not require the venture to be profitable. As they are production related, their make-up may have an impact on the production profile. They are less regressive than bonus payments, since they at least require production and thus some revenue generation, but they are less progressive than income or profit-related payments.

Profit-related fiscal instruments give rise to government share around the time the venture becomes profitable. **However, there are aspects of profit-related instruments that may front-load through ring-fencing or other types of limitations of cost recovery, which accelerate the moment of taxation and impose taxes before the investor, on an overall basis, is profitable.**

Uplifts and accelerated depreciation, on the other hand, push the moment government share is achieved through profit-related fiscal instruments further into the future. Depending on how the depreciation regime is set up, these instruments generally have a positive impact on the level of asset investment.

Figure VII.1:

### Life cycle of an extractive industry project



### Overall objectives

To evaluate whether fiscal instruments achieve overall governmental objectives, it is important for the host country to ensure clarity



and transparency on its objectives. Various fiscal instruments in the extractive industries give rise to specific consequences besides the generation of revenue.<sup>253</sup>

### Progressivity versus regressivity

A potential proxy for assessing the risk/return balance is the progressive versus regressive nature of a fiscal instrument.

Profit taxation is progressive to the extent the tax burden increases if the taxable base increases—that is, it both incentivizes incremental investment in small opportunities (which may be marginally economic) and provides a proportionally higher share of the economic rent to the government at commodity prices or if large discoveries are made. Progressivity is particularly important in the later stages of the basin life where the size of discoveries becomes smaller and smaller. It helps to manage the risk that discovered resources might be left in the ground. Progressive systems can also be designed to cater for differing conditions, such as water depths, remoteness of locations, production levels and discovery size.

Progressive fiscal attributes often make it easier to ensure that the interests of all parties remain aligned over the life of the venture, and under a wide range of macroeconomic conditions. R factors<sup>254</sup> or internal rate of return (IRR) creaming mechanisms<sup>255</sup> are examples

---

<sup>253</sup> International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation*, (2012), p. 19, available at <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>. See also Chapter 1 (Overview), including its discussion of principles for extractive industry investment in developing countries.

<sup>254</sup> R factor is a ratio of revenues to expenses. R factors deal with various revenues versus expense variables that affect project economics depending on how they are defined; for example, some are defined considering gross revenues instead of net earnings. R factors can be determined on accrued total expenditures or on a field-by-field basis. In general, the use of R factors reduces an investor's potential upside from price increases, but also protects the downside.

<sup>255</sup> Creaming mechanisms are any aspects of a fiscal regime that increase government take in the event of an increase in revenue. Some are more balanced than others. For example, an increase in royalty rates related

of fiscal attributes that are progressive in nature. Value-based creaming mechanisms, for example, can be tuned to ensure that the government keeps an appropriate share of the economic rent from the natural resource development interests regardless of the commodity prices. This avoids the need for arbitrary/unilateral increases in levels of taxation, which may not always be reduced when prices fall (i.e., the “ratchet” effect); taxation levels should respond automatically to changes in both cost and revenues.

Windfall profit taxes are not always progressive, due to the cyclical nature of the extractive industries and commodity pricing. It can be difficult to determine what constitutes a windfall for such industries. For example, should the determination of whether or not extraordinary or windfall profits have been realized be made on a one-year comparison basis or should the long-term and cyclical nature of an extractive industries investment be considered?

Ring-fencing is not progressive; ring-fencing occurs when a portion of a company’s assets or profits are taxed separately even though they are not part of a separate entity. Ring-fencing in the context of oil and gas generally moves the moment of taxation forward—often before profitability of a venture—and it influences the risk/return balance. In the context of oil and gas, where assets are ring-fenced on a well basis or on a field or licence basis, the revenue generated by one field or licence will not be offset against the losses generated by another field or licence of the same investor, thus giving rise to tax payments irrespective of the fact that the investor may not be profitable overall. In the mining context, ring-fencing applies with respect to surface mining.

While royalties can be very attractive to host governments (by providing early revenues) they are by nature regressive. In some cases, they may result in resources being left in the ground, either by (i) early termination of economic cash flows (i.e., early abandonment); or (ii) making small discoveries uneconomical to develop, since they can

---

to price increases is considered less balanced by investors than a sliding royalty rate based on internal rate of return (IRR). An increase in commodity price will generally induce an increase in cost, something not considered in a change in royalty rate based on price alone.

result in governments taking a proportionally larger economic share of small discoveries and a smaller share of large discoveries).<sup>256</sup>

For example, over the life of oil and gas basins, many royalty systems have had to be changed frequently by governments wishing to remain competitive and to continue ensuring that investments in improvements are made. Effectively, the changes have been made to give a royalty system features of a profit-based system, thereby making it more progressive.

While some governments have chosen to abolish royalties (e.g., Norway and the United Kingdom) for the reasons outlined above, they remain a popular choice for governments that seek to guarantee early cash flow in the life of an oil or gas field development. However, absolute royalty levels need to be carefully considered so as not to lead to the regressive and counter-productive attributes described above.

The desire to tax revenue rather than profit is generally disfavoured by investors because in times of low commodity prices, companies are likely to be in a financial loss position for a considerable period of time. In spite of that, companies will still be required to make royalty payments. Thus, taxes on profit rather than on revenue generally remain the preferred fiscal model of investing companies. Policymakers therefore need to be aware of the potential regressive nature of fiscal instruments—or certain aspects of regressivity that exist—so that they can strive to achieve and maintain a satisfactory balance between various concerns for resource holders (e.g., timing of the income) and investors.

---

<sup>256</sup> For example, assume Projects A and B each produce 100 units, but Project A earns net income of \$100 and Project B, because of higher costs, earns net income of \$50. A 20 cent/unit of production flat rate royalty will take 20 per cent of the income from Project A, but 40 per cent of the income from Project B. Costs for smaller developments tend to be proportionately higher than costs for larger developments (e.g., the cost of casing a well for a small development will cost the same for a well producing more or a well relating to a larger oil and gas deposit). Therefore, a flat rate government take on a small development will be relatively heavier than on a larger production. This disproportionality in comparison to profitability can be addressed by applying a sliding royalty rate—related to R factors, for example.

## Issues of interaction

Fiscal systems for the extractive industries have continued to proliferate and gain in complexity over time. Governments should assess the economic impact from the utilization of several different fiscal instruments. They should analyse how the fiscal instruments relate to each other and how they interact with the general tax legislation.

### *Risks of interaction between various fiscal instruments*

Each of the various instruments serves specific objectives and can promote certain intended behaviours.<sup>257</sup> However, once various instruments are combined, the intended objective can be counteracted by other considerations. For example, subjecting the extractive industries to a royalty system can more quickly provide governments with revenue. It is, however, a regressive system, and when combined with other regressive instruments, such as a signing bonus or a ring-fenced system, a tax system can become so front-loaded that it becomes uncompetitive. This may delay exploration or production, leading to reduced or no revenue.

## Delineation issues

Where various types of taxation or rates are combined, the delineation of costs and revenue will require special attention in the legislative process and/or in the contract design and negotiation.

The rules need to be clear and precise as to which costs and which revenue belong in which instrument. If not, the overall fiscal and tax regime becomes unclear in its results. For example, in cases where activities are ring-fenced, the legislator should determine against which revenues the costs are to be deducted. It is not always clear which activities are covered within each ring-fenced instrument and a specific separation or allocation of costs is not always possible. When costs are incurred that do not relate uniquely to one well or pit, allocation keys may need to be agreed. Since the costs associated with the extractive industries tend to be quite high, the risk of not being able to deduct appropriately is highly problematic.

---

<sup>257</sup> See International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012), p. 19, for a summary of various instruments and the key objectives they serve.

Enforcement equally poses additional concerns and may become cost prohibitive. Countries may want to consider including examples of tax base calculations into legislation and/or commentaries to the legislation, or implement agreed upon and embodied in regulations that have the effect of legislation. Delineation issues are especially relevant in profit-based taxation as well as in capital gains taxation.<sup>258</sup>

## **Interdependency**

When using multiple taxation instruments, it is important to determine how the various taxes relate to each other. Some taxes are deductible costs in computing other taxes. For example, pipeline fees or royalties are often considered tax deductible costs for profit-based taxes. In other cases, the various taxes may be credited against each other.

If the various instruments provide revenues to various government institutions (e.g., with some revenues going to the Ministry of Minerals and others to the Ministry of Finance), it is important to ensure full understanding and agreement of the matter by all of the different government entities to ensure a sustainable enforcement.

The interdependency with subnational taxation also needs to be addressed and clarified. It is important to know whether the taxation at various levels can be credited or deducted.

Each of these issues, if not clarified, will increase uncertainties and risks, adversely affecting the risk profile of the country from an investor standpoint, and consuming resources of the government in their ultimate resolution. Avoiding an inefficient use of such resources and providing clarity from the outset benefits both the country and the investor. Again, agreeing on numerical examples of how the taxes and levies are to be computed and detailing these in contracts or regulations upfront can avoid uncertainty upon assessment.

## **Interaction between extractive industries taxation and general taxation**

It is not always clear how to deal with the production that is allocated under a PSC in conjunction with general corporate income tax system.

---

<sup>258</sup> See Chapter 4 (Indirect Transfer of Assets).

Production can be shared in cash or in kind. There are various aspects that can have interactions with general corporate income taxation. It is important to understand how production sharing is done, and how and where the volume of the production and the sharing is determined.

Timing, responsibility of measurement, reporting and verification requirements are important, as is the allocation of risks. It is important to understand who will bear the commodity price risk in case production is shared in kind and who bears the exchange rate risk, and for how long, in case of sharing in cash. If the PSC and the corporate income tax are mute on these points, or if the arrangements under the PSC are not in line with the corporate income tax, it will be unclear as to how these issues will be dealt with under the general taxation regime.

When sharing production, the composition of the group of investors and their legal arrangements should also be considered from a tax point of view. Apart from the potential direct tax consequences, the indirect tax consequences should be considered. For example, under PSCs the production tends to be transferred from the government to the operator and from the operator to the joint venture or the joint venture partners. Especially in case of transfers in kind, each of these transfers could be subject to indirect tax at a federal or subnational level. It may not be economically intended to levy tax at each of these transfers, but arrangements need to be made to ensure the applicable laws are complied with and expectations are managed. Again, resolution and clarity of these types of interactions is “common ground”; countries and investors both benefit.

### ***International tax aspects***

It is important to define whether and which part of the fiscal take is considered for foreign tax credit purposes. This is influenced by the provisions of the relevant double tax treaty as well as by the characterization of the tax or levy in the relevant law or contract and by the taxation rules of the home country of a particular investor. Even if the tax or levy is clearly profit related, attention needs to be given to the description and features, especially if agreed in a PSA.

The existence as well as the wording of a double tax treaty and of national taxation in the home country of the investor are relevant for

the eventual tax burden on a project. The interaction between the tax system of the home country of the investor and that of the host country of the investment influences the eventual economics of a project. In other words, clarity in these rules, and oftentimes the existence of a negotiated tax treaty, can allow an investor to enter a higher bid.

### **Relevance of subnational taxation and allocation of revenues**

It is important to consider how the revenue from the extractive industries is to be allocated among the subnational levels of government of the host country. The imposition of taxes and their allocation depend on the country's constitutional, legal and administrative structure.

In certain countries, subnational levels of government have a mandate to introduce their own fiscal instruments. In other countries, only the federal government imposes taxes and subsequently appropriates the revenue.

Without clarity on allocation, the fiscal terms may not be stable as local entities may become dissatisfied with the revenues they are receiving.

### **Issues of enforcement**

To ensure effective enforcement, best practices should be considered when designing, negotiating and applying the applicable fiscal systems.

Best practices should ensure the following:

- (i) A tax administrator must be part of the team to test administrative ease and feasibility of execution;
- (ii) Examples should be included on how to calculate the taxable base as well as taxes due in the relevant legislation or contracts. This should provide clarity to tax administrators and taxpayers on how to implement extractive industries taxation; and
- (iii) Alignments must exist in definitions and enforcement between various taxes, both federal as well as subnational.

The administrative capability of the government can be a limiting factor in the options for fiscal regimes. Using multiple systems can cover multiple policy objectives in revenue raising but often put

additional strain on limited resources. Coordination and exchange of information between departments and parts of government can assist in improving efficiency and reducing costs related to information gathering and audits.

Improving administrative capability could be addressed by creating a dedicated office/unit within the tax administration that focuses on the extractive industries. Sustainable and appropriate resourcing should be ensured when setting up such administration. This would include:

- Appropriate training of staff: audit routines, understanding of the extractive industries (e.g., the mining cycle and risk areas that can impact revenue);
- Appropriate audit tools and equipment;
- Framework to access third party information on production (e.g., from the ministry of mines, energy or customs); and
- Sharing of experiences and knowledge with other countries addressing similar extractive industries issues.

For resourcing and capacity-building initiatives, it is important to include other government departments from the start. Capacity-building is offered by various international organizations and through exchanges with other country tax authorities. Multi-stakeholder capacity-building—involving not only other government officials but also academics and expert business representatives—is not always readily available but can provide valuable information and perspectives. Exchanges with taxpayers that increase capacity can include work on cooperative compliance and other forms of dispute avoidance.<sup>259</sup>

### For more information

Jack Calder, *Administering Fiscal Regimes for Extractive Industries: A Handbook* (Washington, D.C: International Monetary Fund, 2014).

Philip Daniel, Michael Keen and Charles McPherson (Eds.) *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (New York: Routledge, 2010).

---

<sup>259</sup>For example, participation in advanced pricing agreements and processes involving third-party expertise can support capacity development.



- Philip Daniel and Michael Keen (Eds.) *International Taxation and the Extractive Industries* (New York: Routledge, 2016).
- Lindsay Hogan and Brenton Goldsworthy, "International Mineral Taxation: experience and issues", in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*, ed. Philip Daniel, Michael Keen and Charles McPherson (New York: Routledge, 2010), p. 122.
- International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012) available at <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>.
- Daniel Johnston, *International Petroleum Fiscal System and Production Sharing Contracts* (Tulsa: PennWell Books, 1994).
- Honore Le Leuch, "Recent Trends in Upstream Petroleum Agreements: Policy, Contractual, Fiscal, and Legal Issues," in *The Handbook of Global Energy Policy*, ed. Andreas Goldthau (New York: Wiley, 2013).
- Carol Nakhle, "Petroleum fiscal regimes: evolution and challenges," in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*, ed. Philip Daniel, Michael Keen and Charles McPherson (New York: Routledge, 2010) p. 89.
- Open Oil, *Oil Contracts--how to read and understand them*. Available at <http://openoil.net/understanding-oil-contracts/>.
- Silvana Tordo, *Fiscal Systems for Hydrocarbons: Design Issues*, World Bank Working Paper No. 123, (Washington, D.C.: World Bank, 2007).



## Chapter 8

# TAX ASPECTS OF NEGOTIATION AND RENEGOTIATION OF CONTRACTS

### Executive summary

The purpose of this chapter is to provide an overview of some of the tax and fiscal-related issues developing countries face in the negotiation and possible renegotiation of long-term natural resource contracts. It will also provide some additional perspective on the negotiation and renegotiation process. This is intended to help developing-country policymakers and administrators, and to provide information to other stakeholders, on both substantive and procedural approaches to agreements between such countries and the investors they seek to attract in the development of their potential oil, gas, and mineral resources. The background contained in this chapter is intended to provide a broader context for options and approaches available in negotiating long-term contracts.

### Background

Developing countries offer prospects for major extractive industry investments over the next several decades. It has been estimated that, in the energy sector alone, \$48 trillion of investment in energy supply and efficiency will be needed until 2035,<sup>260</sup> with the bulk of that being in emerging economies. How countries attract outside investment while balancing their economic, environmental, and social needs is a major challenge, requiring careful upfront planning and priority setting. In some countries, laws are independently enacted governing the framework for investments in resources, and investors must determine whether they will invest based upon those prescribed rules.<sup>261</sup>

---

<sup>260</sup> International Energy Agency, *World Energy Investment Outlook 2014*, p. 22, available at <https://www.iea.org/publications/freepublications/publication/WEIO2014.pdf>.

<sup>261</sup> Some countries might also have prescribed rules for the mining sector, but which may not be entirely appropriate for the oil and gas (O&G) sector, and vice versa.

In many developing countries, however, where resource development is beginning, a fully developed, detailed sector-specific framework may not exist, and thus many of the fiscal elements governing a natural resource development project may be established by negotiations between an investor and the government. It is generally beneficial to define as many of the natural resource development rules as possible, including fiscal terms, in legislation, leaving only limited matters to negotiation. This ensures consistency and transparency, while allowing for flexibility to address some project-specific considerations. However, in the early stages of resource development, where the rules are evolving, countries may in practice rely on project-specific contract negotiations for many items governing natural resource development, including key fiscal terms.

This chapter will review various considerations and concerns of governments and investors involved in a natural resource contract negotiation, or possible renegotiation as circumstances or parties the involved change, with particular attention to tax and fiscal issues. While the most common tax issues will relate to the provisions directly affecting government take—such as royalties, income and additional profit taxes, withholding taxes, VAT, and export taxes—other contractual terms (e.g., decommissioning or requirements to fund infrastructure) and even the procedures in negotiations, can have tax implications. Some of those more important concerns are also addressed in this chapter.

The ultimate objective for both the government and the investor in a natural resource development project is success over a very long-term period. The nature of the original agreement terms should provide a structure that maximizes chances to achieve results beneficial to government and investor alike. It should also promote an arrangement where, as differences of view arise over the course of the 20–30+ year relationship, the parties agree to work together to resolve those differences in a mutually satisfactory way.<sup>262</sup>

---

<sup>262</sup> Two very helpful resources covering a wide range of issues in natural resource contracts are “Mining Contracts—how to read and understand them” (hereafter “Mining Contracts”) and “Oil Contracts—how to read and understand them” (hereafter “Oil Contracts”). These sources contain a wealth of information, examples and considerations related to understand-

## Interrelationship with other chapters of the Handbook

Where other chapters of this Handbook cover particular issues more directly, they will be referenced in this chapter. To avoid duplication, the reader is invited to review the more specific text in those chapters. In particular, Chapter 1 (Overview) provides a context for understanding the nature of the oil and gas (O&G) and mining industries, including the various phases in the lifespan of natural resource projects (i.e., exploration, development, production, processing and decommissioning). The Chapter 1 overview also summarizes the types of fiscal regimes that generally apply in these industries, while Chapter 7 (The Government's Fiscal Take) provides additional important detail on the elements of such regimes. Together, they provide additional context for the issues reviewed in this chapter.

## Negotiation background: country perspectives

### *Balancing investment attractiveness with obtaining resource value*

In designing a fiscal plan for developing resources, one key objective is maximizing the present value of government revenues. Other important objectives also exist, such as employment creation, training, local content, infrastructure requirements and environmental concerns.<sup>263</sup>

---

ing and negotiating long-term natural resource contracts, as well as basic information about the mining and O&G industries. They each also contain extensive and helpful glossaries of mining and oil terms, and are available for free download from <https://s3.amazonaws.com/s3.documentcloud.org/documents/1279596/mining-contracts-how-to-read-and-understand-them.pdf> (for mining contracts) and <http://openoil.net/understanding-oil-contracts/> (for oil (and gas) contracts). In addition, the International Institute for Sustainable Development has published the IISD Handbook on Mining Contract Negotiations for Developing Countries, Volume One: Preparing for Success (April 2015) (hereafter "IISD Handbook") available from <http://www.iisd.org/sites/default/files/publications/iisd-handbook-mining-contract-negotiations-for-developing-countries-volume-1.pdf> with legal background on contract negotiations as well as negotiating preparation and implementation procedures and practices.

<sup>263</sup> See International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012), p. 13.

When seeking an investor to bear some or all of these costs along with the other risks associated with developing resources, a country will also need to consider what terms are required to provide investors an adequate return for the risks they take.

A country may address these issues in its statutory provisions related to resource activities, or it may address them on a project-by-project basis via contractual negotiations. These may be based upon a model contract, but in practice, such a model tends to be a guideline, or a country's "opening position" in what becomes a more specific negotiation, taking account of the specific characteristics of the particular resource to be developed.

Ideally, whether in a statutory or contractual mechanism, the terms and conditions for natural resource projects should be flexible to meet government and investor objectives over an extended period of time, and under different and changing price and cost environments. This can be advanced via a choice of various fiscal tools but, in many cases—in more extreme circumstances—the agreement of the parties to re-open or renegotiate certain provisions is included in contracts.

### *Priority setting*

As suggested in the Overview, a key starting point in establishing a fiscal regime, via a general statutory approach or in a particular contract negotiation is for the country (and the investor) to identify its principles, priorities, and objectives to be achieved.<sup>264</sup> This can take a fair degree of time, and involve input from multiple stakeholders in the planning process.<sup>265</sup> Once a set of objectives is determined, the

---

<sup>264</sup> See the Background section of Chapter 1 (Overview) of this Handbook.

<sup>265</sup> See, for example, the extensive work done in developing the Mozambique Natural Gas Development Plan, available at <http://documents.worldbank.org/curated/en/324191468054279630/pdf/806830WP0Mozam0Box0379812B00PUBLIC0.pdf>; Uganda's Vision 2040 covering overall country development, but noting the importance of contributions to be made by the O&G and mining sectors, available at <http://npa.ug/wp-content/themes/npatheme/documents/vision2040.pdf>, pp. 47–51; specifically for mining, see the African Mining Vision and "Building a sustainable future for Africa's extractive industry: From vision to action," particularly the key tenets of the Vision and programme clusters, available at [https://au.int/sites/default/files/documents/30995-doc-africa\\_](https://au.int/sites/default/files/documents/30995-doc-africa_)

ongoing design of the fiscal regime and other key statutory or contractual conditions should be tested against their impacts on achieving the base objectives.

One of the benefits of relying on a statutory approach for fiscal regimes is that it can embody the agreed upon objectives and ensure consistency among projects.<sup>266</sup> Where more of the terms are left to negotiations, the risks increase that the ultimate contract will not be as fully consistent with the country's agreed upon priorities.

Experts increasingly suggest that the model with more detailed laws and regulations (...) creates a stronger foundation upon which a country can manage its extractive industries according to national priorities. In addition to helping investors to feel like they are being treated equally across deals, consistent terms across projects can streamline monitoring for government institutions. A robust legislative framework may also result in greater public input because the public can more easily participate in the legislative process than in individual contract negotiations.<sup>267</sup>

Whereas some of the fiscal regime provisions are included in statutes while others are negotiated, the negotiations present the

---

mining\_vision\_english\_1.pdf, p. 9. Also see the Natural Resources Charter, Precept 1, which states “[e]ffective and sustainable resource management requires an inclusive and comprehensive national strategy. To achieve this, the government must make a series of key decisions that will affect different groups and set choices extending far into the future. To avoid making decisions in a piecemeal fashion and to build a shared sense of direction, governments should, in dialogue with stakeholders, use a national strategy process to guide extractive resource management decisions.” Available at [https://resourcegovernance.org/sites/default/files/NRCJ1193\\_natural\\_resource\\_charter\\_19.6.14.pdf](https://resourcegovernance.org/sites/default/files/NRCJ1193_natural_resource_charter_19.6.14.pdf), and IISD Handbook, section 4.5.1, pp. 49–50.

<sup>266</sup> Consistency among investors and projects can be important from a non-discrimination and anti-corruption perspective. A further benefit to consistency in terms and terminology that a statutory approach provides is the facilitation of administration and compliance enforcement.

<sup>267</sup> Natural Resources Governance Institute, *Legal Framework: Navigating the Web of Laws and Contracts Governing Extractive Industries*, NRG Reader (March 2015) p. 6. Available from <http://www.resourcegovernance.org/analysis-tools/publications/primer-legal-framework>.

very real risk that conflicts may arise between statutory rules and the contract provisions. This is addressed more fully below in the context of having tax and customs representatives involved in fiscal terms negotiations to ensure enforceability of the contract terms and their conformity with the statutory provisions in place.<sup>268</sup>

***Parties involved from the country standpoint  
(internal and external stakeholders)***

A key factor that distinguishes natural resource development from many other investments is that they involve “exhaustible” resources—considered to be country assets, the benefit of which should belong to the people of the country. In addition, considerations of how those benefits are shared between current and future generations are also involved. Finally, while the benefits are often viewed as benefitting the entire country, the disruptions that naturally occur in development activities can disproportionately be borne by the region or locations where most of the activities are conducted. Thus, special consideration for such localities must be taken into account.

***National government representatives***<sup>269</sup>

The establishment of a country’s taxation and fiscal regime is a complex exercise, given the many issues involved and, in terms of governmental responsibilities, the numerous agencies or departments involved or affected. Thus, broad collaboration is essential. Benefits of

---

<sup>268</sup> Where a statutory rule is no longer realistic, or is not sufficiently flexible to accommodate projects that country negotiators wish to have developed, it is arguably better to adjust the statutory rules themselves than to seek to override or modify them via a contract. An attempted “override” may simply be unenforceable, and lead to conflicts and ambiguities that only increase risk and uncertainty.

<sup>269</sup> While this chapter addresses taxation issues, and thus the following subsections focus on Finance and Resources (petroleum and mining) ministries, there are of course many other national level ministries (or organizations) that need to be included, such as ministries overseeing health, safety and environment, labour and employment, and of course any national mining or oil company. Even when the focus is on taxation and other more purely fiscal terms, involvement of these other representatives is often important since they will provide valuable input into the underlying objectives in their areas. Similarly, even when non-tax or fiscal terms are discussed, inclusion of



establishing a regime under a statutory approach, in addition to those already noted, include the likelihood of this broad range of input being obtained, and a higher degree of transparency being achieved. When a country determines its regime under a contractual, project-by-project approach to resource development, the challenges of appropriate and full participation are greater. Even in this case, however, establishing a “model contract” can be a productive exercise and a means of obtaining input from as wide a group within government as possible.<sup>270</sup>

Further, in light of the long lead times in generating production (and, following that, net revenues after cost recoveries), clear descriptions of project results, and their timing, should be communicated. This will help to anchor expectations, particularly with respect to the timing of anticipated benefits, in a realistic context.

### *Finance ministry/planning ministry*

Given the key importance of taxation in contract negotiation (including all forms of government take), it is essential that the Ministry of Finance be included in development of objectives, in statutory regime structuring, and specific contract negotiations, as the case may be. In collaboration with the Ministry of Finance, the further involvement of the tax administration, as well as the Customs Administration is essential.

Ministry of Finance and tax administration representatives bring skills to the negotiating team that are particularly important, including the likelihood of being able to conduct economic and

---

tax representatives is important since decisions in those areas will no doubt have tax impacts that should be understood and carefully considered. See, for example, *Mining Contracts*, pp. 22–24. Generally, the parties involved should be largely symmetric, as between the government and the investor.

<sup>270</sup> See, for example, Liberia Model Production Sharing Contract, available at <http://www.eisourcebook.org/cms/Liberian%20Production%20Sharing%20Contract.pdf>; Tanzania Model Production Sharing Contract, available at: <http://www.tpsc-tz.com/wp-content/uploads/2015/04/1-MPSA-2004-Ver-7-0-12-11-2004.pdf>. Mexico’s National Hydrocarbons Commission documents, available at <http://www.gob.mx/cnh/#documentos>; and Timor Leste Model Production Sharing Contract, available at <https://www.laohamutuk.org/Oil/PetRegime/PSC%20model%20270805.pdf>.

financial modelling of the impact of various negotiation proposals and a knowledge of tax policy and practice to assist in determining and evaluating the composition and approach regarding which fiscal tools to use.

Further, involvement of tax administration representatives in the negotiation process creates a better understanding of how the provisions are intended to operate in practice and ensures that they can in fact be implemented as intended. Many examples exist where without involvement of the tax (and customs) administrations, a negotiation will result in provisions that are contrary to the existing tax laws (including tax treaties) or may use terms that have different definitions under such tax provisions than the negotiators may intend, creating immediate ambiguities, if not outright conflicts, in the interpretation of the agreement and its enforceability under the other statutory requirements in place.<sup>271</sup> In a recent African Tax Administration Forum (ATAF) meeting, one country representative noted that its tax administration, which had not been involved in a negotiated contract, found itself unable to implement the terms of a negotiated contract, since they were in conflict with the specific tax laws of the country. This forced a renegotiation of a contract that the investor and the government negotiators had signed (and thought was finalized). This

---

<sup>271</sup> See, for example, a recent Parliamentary Briefing issued by the Natural Resource Governance Institute noting, “Through their oversight role, parliamentarians should (...) [e]nsure that all legislation affecting the fiscal elements of oil, gas and mining projects are coherent. Some countries have wrestled with inconsistencies between pieces of legislation.” Getting a Good Deal from Oil, Gas and Mining Parliamentary Briefing January 2015 Fiscal Regimes for Oil, Gas And Minerals, in [http://resourcegovernance.org/sites/default/files/documents/nrgi\\_fiscalregime\\_20150311.pdf](http://resourcegovernance.org/sites/default/files/documents/nrgi_fiscalregime_20150311.pdf), p. 4. While ambiguities in statutory interpretations can occur, generally providing for as many of the fiscal terms as possible in statutes, and minimizing the terms that are agreed to via separate contracts, will help to reduce ambiguities. Ghana presents an interesting dichotomy here given that it has traditionally provided the fiscal terms in the mining sector on a negotiated contract basis, while it is generally standardizing terms in the oil and gas sector by means of statutory requirements. Further, the language differences of negotiators, and differences between the language in which the negotiations are conducted and the ultimate contract language, can affect how agreements are understood by the parties, and is another area that can generate ambiguities.

result can be largely eliminated by including tax and customs administrations in the negotiation process.<sup>272</sup>

Such inclusion can be achieved by having representatives of the affected agencies on the negotiating team or, at a minimum, available to and regularly consulted by the team throughout the process. It is equally important that investors work with the negotiating parties to clarify that such involvement and consultation is undertaken.

Uncertainties that may exist in implementation of any aspect of the agreement will simply increase the risks the investor will see, and will therefore affect the terms of the negotiations. Reducing these types of risks is beneficial to all.

Full inclusion in the negotiating process may sometimes be harder to achieve in very limited negotiations, and is one reason to avoid those processes. Where that is not possible, it is again in both the country's and the investor's interest to minimize risk through consultations with tax and customs representatives.

### ***Resource (petroleum and mining) ministries***

The petroleum or mining ministries will clearly be involved in contract negotiation and in some, if not all, of the fiscal (government take) structuring. They are most likely to know the asset characteristics (e.g., the geology, market and necessary infrastructure) that are key elements in understanding and estimating the value of the resource itself. Again, however, given the clear overlap with numerous tax issues, the resource ministries should coordinate closely with the finance ministry (and tax and customs administrations) to ensure full enforceability of the arrangements and complete understanding of their economic effects.

---

<sup>272</sup> Another example of conflicts between contracts and statutes involved a country where separate contracts negotiated with a number of mining companies specified different periods for the carry-forward of losses for tax purposes. In some cases, the contracted period was longer than the country's statutory one, while in other cases it was shorter. Each of these presented issues of interaction between the contract and the existing tax law, and provided outcomes that could be much different from what the negotiators intended.

In the fiscal regime planning stage, it is important to have robust economic (including tax) modelling tools to evaluate the impacts of the various options and fiscal tools that ultimately will form the overall fiscal regime. Similarly, where some or a large portion of that regime is developed under a project negotiation, having project-based economic modelling tools is essential. Those with knowledge of the specific resource need to combine efforts with those with the financial and economic evaluation skills to understand the predicted outcomes under numerous scenarios, such that they are fully prepared for how the negotiations will transpire and can provide key information to the ultimate decision makers.

Before finalizing an agreement, an important “best practice” is again to work through all of the proposed fiscal terms under several development and production scenarios, doing so with input and computations developed or reviewed by the agencies responsible for each particular item of significance (i.e., customs agencies on duties, tax administrations on various taxes involved, natural resource and finance ministries for royalties and other financial payments, etc.). Doing this in as much detail as possible can ensure alignment and understanding within the government, and between the government and investor, of how the terms are intended to operate in practice and can provide the opportunity to revise or clarify provisions where ambiguities are found.

To achieve full benefit from the concession contracts it negotiates, the Government will have to effectively monitor, and ensure compliance with, the terms of its negotiated agreements.<sup>273</sup>

Thus, having a complete and agreed understanding of what the negotiators intended the agreement terms to mean is a clear prerequisite to ongoing successful implementation, monitoring, and enforcement.

---

<sup>273</sup> Raja Kaul and Antoine Heuty with Alvina Norman, *Getting a Better Deal from the Extractive Sector—Concession Negotiation in Liberia, 2006–2008*; A report to the Liberian Reconstruction and Development Committee Office of the President (hereafter Liberian Renegotiation Report) Republic of Liberia, Revenue Watch Institute, 2009, p. 77.

### *Regional and local counterparts*

In addition to ensuring that all relevant governmental concerns at a federal level are addressed, it is also very important to involve regional and local governments—those where the operations will take place—in the planning stages (i.e., before an area is opened up for exploration or for bidding, and before activities commence) and in the negotiation process. While this is a clear issue in terms of how the project will actually be physically implemented (with roads, port expansions and other infrastructure directly impacting local and regional areas) the actual mechanism by which a fair sharing of government revenues occurs is a critical issue that should be covered by statute or a negotiated contract. Failure to address this issue adequately—both at the planning stage and during the negotiations—can lead to project delays and inefficiencies as well as disruptions due to local discontent.

### *Negotiation team participation*

The makeup of the country negotiating team is a key issue. While the team conducting the actual negotiations with potential investors cannot practically include all interested and important members, a mechanism to ensure their input is critical to the success of the negotiation.

There is no one structure for government negotiating teams. Practice is diverse across the globe. (...) It should be noted that bigger is not necessarily better when it comes to seats at the table. A single negotiator or 3–4 negotiators may be much more efficient than a group of 15. Confusion, distraction, and divide-and-conquer techniques can be employed for large negotiating teams.<sup>274</sup>

One framework to consider is having a relatively small core negotiating group that conducts the formal negotiations, with a larger team of negotiation advisers who provide relevant input before and throughout the negotiation process on issues consistent with their expertise. In addition, when particular negotiating sessions focus on

---

<sup>274</sup> Mining Contracts, pp. 22–24. See also “Truth 45: Building the winning negotiating team,” in Leigh Thompson, *The Truth About Negotiations* (Upper Saddle River, N.J.: FT Press, 2008), pp. 169–171.

certain specific issues, it may be appropriate to include in the session the subject matter expert. For example, if there are specific taxation issues that are to be negotiated, a government tax representative could be included in that session, even if financial issues are otherwise handled by the Ministry of Finance.

How the political dimension of a negotiation is handled, including interaction with the negotiating team, is a critical issue. The Liberian renegotiation study noted the benefit of strong and engaged leadership:

President Sirleaf’s leadership in the ArcelorMittal and Firestone negotiations was key to the success Liberia achieved. From the beginning of the process, the President managed the negotiating process and allowed a direct reporting line from the Chairman of the negotiating team to herself. Among other things, President Sirleaf (...) clearly communicated a vision of national priorities to the nation and investors (...).

The President’s leadership (...) displayed her consistency, integrity (the negotiation team knew they could count on her backing if needed) and involvement. She sought updates, listened to the negotiating team and its advisors, was accessible, was a consensus builder, held people accountable, had substantive knowledge of the issues being negotiated, and was decisive.<sup>275</sup>

### *Communication protocols*

A mechanism to ensure robust communication among the negotiating team and advisers is important to achieving a successful outcome and an agreement that can be implemented as intended. For example, almost all issues have a tax implication—whether it is income, VAT, excise, customs, withholding or individual taxation matters—including, where applicable, tax treaty issues. It is therefore always helpful to

---

<sup>275</sup> Liberian Renegotiation Report, p. 9. See also the IISD Handbook, Section 4.4.5, p. 45: “The role of the Minister or President in any negotiation is critical. It can be extremely constructive when Ministers are fully onside with the negotiating strategy, and very destructive to longer-term national goals when short-term personal or political goals are at the forefront of their individual objectives.”

ensure tax issues are understood by the negotiators. To illustrate, the termination provisions of a contract will likely provide some requirement to reclaim and restore the mining or oil and gas (O&G) production sites. The issue of who will bear this cost and how those costs are addressed under the country's tax law (or if the negotiators wish to provide tax treatment under the contract) are key to the economics of the deal. Negotiators not expert in tax matters may not immediately appreciate the tax implications of various options for addressing this issue. Having an effective communication procedure in place with advisers will ensure the negotiators understand and account for the tax effects of various proposals. See Chapter 6 (the Tax Treatment of Decommissioning) for additional detail on this topic.

When negotiations are at certain critical stages, there may be concerns about information sharing outside a relatively small group. Again, however, that group should ensure that it has a full understanding of the tax implications of the decisions being considered. The best way to ensure this is to include a tax representative within that group; failing to do that, the next best approach is to have a consultation with the tax representative and fully explaining what is being proposed. In this context, the tax representative needs to be entrusted to understand the full context of the issue—in some cases, country tax representatives have noted that they have been asked “hypothetical” or “piecemeal” questions, and this can lead to responses that are different from what would apply if the full context of the facts involved were known.

### ***Model issue notes***

One way to provide input where individual involvement may not be practical is via written issue notes on items of importance. For example, a tax administration note outlining some of the basic rules in the tax law applicable to resource investments could further highlight that if the negotiators desire to deviate from statutory rules, they will need to obtain legislative amendments or the tax administration will be unable to implement them. In addition to model issue notes that may be provided as background within a negotiating team, explanatory notes may also be helpful, and exchanged, with the opposite negotiating team. This can help negotiators from both sides to have the same understanding of how tax provisions important to each side operate in practice. When creating issue notes—meant either for one's own

team members or to be exchanged—making a record of the note and its transmission details is a best practice.

### ***Other stakeholders and constituents***

Consultation with non-governmental stakeholders in the planning and implementation of awarding resource contracts, or in structuring a statutory regime covering resource development, is important for generating trust in both the process and the outcome of such activities. Community engagement prior to any negotiations and during the process itself can be a key factor in gaining community support. Such consultations and ongoing input also need to be appropriately managed in terms of time frame and subject matter. As noted in the context of the Liberian contract renegotiations,

[a] majority of government officials—including the President—are favourable to consultations with non-governmental stakeholders as long as they are time-bound and focused. Consultations with non-governmental stakeholders should take place early in the concession award process as part of the bid tender, evaluation, or award process. If there have been no consultations as part of the process to select the concessionaire, then a time-bound and focused consultation at the outset of the contract review phase is advisable.

Some in the Government have pointed out that soliciting third-parties' input during the concession negotiation phase runs the risk of breaching the confidentiality required during negotiations. The development of a non-governmental stakeholder consultation mechanism should be done. (...) Prior to finalizing such a mechanism, input should be sought from non-governmental groups such as community representatives and labour unions.

Consultations with stakeholders should occur as part of the concession bid tender, evaluation and award process. If this is not possible, then consultation with non-governmental stakeholders should occur as part of the contract review process. In adopting rules for consultations with stakeholders, the Government should require that such consultations occur early in the negotiation process (i.e., during the contract review



process *and* prior to the development of a draft term sheet); as part of a formal public process; and in a time-bound and focused manner.<sup>276</sup>

Some outside groups push for inclusion on the negotiating team but this is usually not accommodated. The more common practice appears to be consultation prior to and at appropriate times during the negotiations, plus review of the draft final contract. Each country will have to determine the best-balanced approach to this issue.

There are often times during the negotiations when confidentiality is important. There may be proposals and counterproposals on important negotiating points, including proposed trade-offs among various terms. Negotiations conducted “publicly” on these positions are far less likely to be successful.<sup>277</sup> Nevertheless, the final product, including explanations of the various trade-offs embodied within it, should be available for review and comment. Negotiators should also be prepared to explain their final positions taken in concluding the overall agreement.

### *Outside adviser resources*

It is often stated that investors negotiating natural resource development agreements possess asymmetric information and skills, given their technical expertise and greater experience in such matters. There are several ways to address this issue, depending on time and resources available.

First and foremost is to identify the information and skills the government needs (e.g., valuation of the resource or project, overall

---

<sup>276</sup> Liberian Renegotiation Report, p. 61.

<sup>277</sup> The substantive renegotiation by Liberia of the ArcelorMittal iron ore and associated minerals concession contract begun in New York for several reasons, including the consideration that “(...) [h]aving the discussions in New York also increased the Government’s chances of maintaining confidentiality around the negotiations. The Government and its technical advisors felt that strict confidentiality at this stage of the process was absolutely necessary if Liberia was to succeed in its bid to renegotiate the MDA [Mineral Development Agreement]. Everyone acknowledged that negotiations conducted through the press would make it harder if not impossible for the Government to reach agreement with ArcelorMittal”. Liberian Renegotiation Report, pp. 33–4.

market analysis, legal or other negotiation skills, environmental expertise and economic modelling) and then identify which of these can be adequately covered from within the government itself. In many cases, countries do in fact have the knowledge and skills required and should take full advantage of these resources. Where it is determined that gaps exist, or where additional augmentation is desirable, identifying options and putting together a plan for dealing with these is the next step. A number of possible approaches exist.

One option is to hire outside advisers as needed to meet the country's needs. While a great number of organizations are available to provide natural resource project support—some on a pro bono basis and others on a partial or full funding approach—when a country is preparing to embark on serious, substantive negotiations, there is no substitute for hiring technical, legal and financial advisers from the private sector for pre-negotiation planning and negotiation support. In some cases, funding support for this may be available, but even where that is not the case, given the overall size and significance of natural resource projects, and the amount of potential revenues involved, the immediate and consistent availability of dedicated service support is worth the cost. Even with all of the expertise that investors have, they often also hire outside assistance. To equalize negotiating strength, it is strongly recommended that where dedicated, longer-term, project-negotiating support is required, countries should seriously consider hiring such high-level, private sector support.<sup>278</sup>

Many organizations are available to provide overall background to a country beginning or enhancing its education on important natural resource development issues. These include well known

---

<sup>278</sup> See, for example, *Federal Ministry for Economic Cooperation and Development, Natural Resource Contracts as a Tool for Managing the Mining Sector*, 2015, pp. 54–56, in support of this point and for a general discussion of the role of outside advisers and the “Question of External Assistance,” available at [https://www.bmz.de/g7/includes/Downloadarchiv/Natural\\_Resource\\_Contracts.pdf](https://www.bmz.de/g7/includes/Downloadarchiv/Natural_Resource_Contracts.pdf). See also IISD Handbook, section 4.4.4, “Outside Expertise: Capacity provision and capacity building,” pp. 47–49. In addition, when a country does decide to hire outside support, a robust and transparent process for identifying and hiring advisers is essential. It would be doubly harmful to incur the costs for an outside adviser that fails to provide the level of technical, financial or legal assistance needed.

international and regional financial and development organizations, assistance organizations supported by one or a small number of countries or other organizations, and numerous non-governmental organizations dedicated to providing support with respect to natural resource matters. These can be quite helpful in providing basic information that is more general in nature, rather than specific technical support for a particular project or contract.

In addition to more generalized information and support, specific project-related negotiations support is also provided by several organizations. An excellent window into the array of advisers, technical assistance programmes, and other advisory and support tools for negotiations is the Negotiations Portal for Host Country Governments.<sup>279</sup> The Portal, operated by the Columbia Center on Sustainable Investment (CCSI) is part of the G7 2014 CONNEX Initiative to “provide developing country partners with extended and concrete expertise for negotiating complex commercial contracts”.<sup>280</sup>

The Code of Conduct for the CONNEX initiative states:

(...) the objective of the initiative is to strengthen advisory support to low-income country governments in negotiation of complex commercial contracts – to make the support that is available more comprehensive and more responsive to government’s needs and to contribute to fairer, more sustainable investment deals. This includes not only the provision of information and capacity building, but also the improvement of advisory services involved directly in contract negotiations.<sup>281</sup>

The CONNEX initiative is especially directed to natural resources.<sup>282</sup>

---

<sup>279</sup> See <http://negotiationsupport.org/>.

<sup>280</sup> The Brussels G7 Summit Declaration, June 5, 2014. Available from [http://europa.eu/rapid/press-release\\_MEMO-14-402\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-402_en.htm).

<sup>281</sup> See [http://www.bmz.de/g7/includes/Downloadarchiv/150505\\_CONNEX\\_Code\\_of\\_Conduct\\_final.pdf](http://www.bmz.de/g7/includes/Downloadarchiv/150505_CONNEX_Code_of_Conduct_final.pdf).

<sup>282</sup> See [http://www.bmz.de/g7/en/Entwicklungspolitische\\_Schwerpunkte/Connex/index.html](http://www.bmz.de/g7/en/Entwicklungspolitische_Schwerpunkte/Connex/index.html).

The CCSI has compiled a helpful database of significant negotiation support organizations, with background and contact information for each of the organizations listed.<sup>283</sup>

A country utilizing pro bono support—or even fee-based support when the fees are paid by others—needs to assure itself as to the quality of the expertise being provided, including that the donor organization’s technical support provider is sufficiently experienced in the particular area where advice is being sought. For example, one would not expect to obtain top-level tax law advice from anyone other than a tax specialist, and thus a securities or contract lawyer should not be utilized to provide the level of technical tax support that might be sought. In addition, a country considering reliance on outside organizations for support should assure itself that the support needed will be timely, and sustained, throughout the negotiation process.<sup>284</sup>

### *Outside legal advisors*

In addition to resources available through organizations such as the International Senior Lawyers Project,<sup>285</sup> and others included in the Negotiations Portal for Host Country Governments list of support organizations, some major law firms make their partners available from time to time to assist countries in negotiating activities. See the Liberia Renegotiation Report summary noting that certain law firms provided valuable assistance to the Liberian negotiating team.

### *Project forecast models*

The International Monetary Fund (IMF) has developed and issued

---

<sup>283</sup> See <http://negotiationsupport.org/providers> for a list of specific organizations that provide support, together with the nature of such support, during the planning, preparation, negotiation, monitoring and implementation stages of natural resource projects.

<sup>284</sup> For a discussion of some of the issues countries should consider when relying on outside support organizations, see Federal Ministry for Economic Cooperation and Development, *Natural Resource Contracts as a Tool for Managing the Mining Sector*, 2015, pp. 54–56. Available at [https://www.bmz.de/g7/includes/Downloadarchiv/Natural\\_Resource\\_Contracts.pdf](https://www.bmz.de/g7/includes/Downloadarchiv/Natural_Resource_Contracts.pdf).

<sup>285</sup> See <http://islp.org/>.

a Fiscal Analysis of Resource Industries (FARI) tool<sup>286</sup> which can model project level cash flows for both petroleum and mining projects. A technical explanation of the model is also available.<sup>287</sup> The FARI model has been successfully utilized in a number of Asian and African countries, and the IMF is available to consult and assist in the implementation in appropriate circumstances by longer-term FARI training to government officials, hands-on modelling workshops and remote assistance from Washington, D.C.

Other investment advisors with modelling capability can be accessed, and the Negotiations Portal for Host Country Governments list of support organizations referenced above can be consulted for some of these additional providers.

As previously noted, economic modelling capability is crucial for governments. The benefits of contract/project-based economic models are summarized as follows:

Governments can use models to experiment with various policy options and measure their impact. They can use them to assess the impact of modification of fiscal terms proposed in contract negotiations in a range of alternative price, cost, and production level scenarios. Companies generally use economic models to assess natural resource tax regimes and for contract negotiation, and governments are at a serious disadvantage if they do not have the same tools at their disposal.<sup>288</sup>

### ***Sample contracts***

A number of sample contracts are available from various sources, including the Extractive Industries Source Book,<sup>289</sup> Open Oil,<sup>290</sup> and Resource Contracts.<sup>291</sup> As of 2013, Open Oil suggested that

---

<sup>286</sup> See <http://www.imf.org/external/np/fad/fari/index.htm#2>.

<sup>287</sup> See <http://www.imf.org/external/pubs/ft/tnm/2016/tnm1601.pdf>.

<sup>288</sup> Jack Calder, *Administering Fiscal Regimes for Extractive Industries: A Handbook* (Washington, D.C.: International Monetary Fund, 2014), p. 95.

<sup>289</sup> See [http://www.eisourcebook.org/676\\_58ContractNegotiationsandDisputeSettlement.html](http://www.eisourcebook.org/676_58ContractNegotiationsandDisputeSettlement.html).

<sup>290</sup> See <http://repository.openoil.net/wiki/Downloads>.

<sup>291</sup> See <http://www.resourcecontracts.org/>. In addition, over 40 Produc-

either model or actual signed contracts were publicly available for Afghanistan, Angola, Azerbaijan, Bangladesh, Brazil, Burkina Faso, Cambodia, Colombia, Congo, Cyprus, the Democratic Republic of the Congo, Ecuador, Equatorial Guinea, Ethiopia, Ghana, India, Iraq, Jordan, Kenya, Liberia, Libya, Mauritania, Mexico, Mongolia, Mozambique, Nicaragua, Peru, Senegal, Sierra Leone, Timor Leste, Trinidad and Tobago, Turkmenistan, Uganda and the United Republic of Tanzania.<sup>292</sup>

Sample mining agreements and models/examples of mining contract provisions are available under the Model Mining Development Agreement Project.<sup>293</sup>

In its directory of Petroleum and Mineral Contracts, Resource Contracts has at least one contract (model or actual) for 89 countries.<sup>294</sup>

## Negotiation background: investor perspectives

### *Understanding country priorities*

Just as it is important for a country to critically evaluate its priorities and key objectives in developing its resources, it is basic to a successful negotiation that the investor engage in ongoing dialogue with the country to ensure a full understanding of the country's goals. Ideally, the initial discussions can be at a high level where basic principles, objectives and obligations are articulated and debated. Seeking to understand the underlying interests that the parties have can often lead to solutions to positions that might otherwise appear to be intractable.<sup>295</sup>

---

tion Sharing Contracts entered into by the Kurdistan Regional Government are available from <http://cabinet.gov.krd/p/p.aspx?l=12&p=1>.

<sup>292</sup> See <http://openoil.net/2013/10/07/openoil-is-looking-for-partners-to-analyse-oil-contracts-around-the-world/>.

<sup>293</sup> See <http://www.mmdaproject.org/>.

<sup>294</sup> See <http://www.resourcecontracts.org/>.

<sup>295</sup> “Negotiators too often state their positions as opposed to their underlying interests. For example, an IMC [International Mining Company] will state that it will not pay income tax above a certain rate and it will not agree to a cap of deductible costs. Meanwhile the government will state that a large front-end payment is mandatory and that taxes are payable on the date of a

***Look for long-term relationships***

Investors will explain that one of their basic objectives is to develop a long-term, mutually beneficial relationship with the country. Agreements that are overly favourable to one side are not likely to be lasting ones and certainly will not operate to maximize the value of the resources to be developed. If overly favourable to the investor, the country will press to renegotiate or simply impose new terms. If overly favourable to the country, the investor will likely terminate the contract at the first opportunity, and development of the resource itself may be jeopardized. Agreements that provide a balance of interests, and which provide some degree of flexibility in case of material and substantial changes in circumstances, can create an underlying contractual structure most supportive of a successful long-term partnership.

***Articulation of investor needs and investor risks***<sup>296</sup>

The extractives industries are unique in many ways. The sector is shaped by high sunk costs in the form of substantial investments that often cannot be recouped if a project is unsuccessful; long lead times from initial investment to project start-up; fluctuating costs and prices that in turn influence the profitability of exploration, development and extraction; volatile demand; very long production/project lives; and substantially greater environmental impacts to address, including ultimately decommissioning or reclamation responsibilities.<sup>297</sup>

---

commercial discovery. If they were talking about their respective interests, the IMC would explain that it needs a minimum Internal Rate of Return (IRR) on its capital to get approval from its Board of Directors, failing which its investment committee will not approve the project. The government would state that it needs income as fast as possible, or it could face mounting political pressures. When interests are clearly expressed, it is easier to see where the parties can compromise.” Mining Contracts, pp. 184–185. See also chapter 3, “Focus on Interests, Not Positions,” in Fisher and Ury, *Getting to Yes* (New York: Penguin books, 1983) pp. 41–57.

<sup>296</sup>For a more complete list of the risk factors investors face, see Table 1.4, “Categories of risk facing an energy investment project,” International Energy Agency, World Energy Investment Outlook 2014, p. 32. Available at <https://www.iea.org/publications/freepublications/publication/WEIO2014.pdf>.

<sup>297</sup>It is important to assess the risks at the time they are undertaken. A simple example illustrates this point. Assume A offers to sell to B a right to

An investor committing to the substantial outlays required for these investments will look for a satisfactory return, taking into account all of the risks the investor bears. This is one reason why it is difficult to compare fiscal regimes and general return levels across countries, since the degree of geologic, political and economic risks varies from country to country and even project to project.

One key consideration that can benefit a country in its negotiations is that the more a country can reduce investor risks, the lower the return the investor will need, and hence the more it will be willing to pay. Investors themselves further seek to reduce risks given the large and usually upfront amounts they make, and hence generally see benefits in stability and predictability of laws and fiscal arrangements.

It's all about risk and reward. If you can help reduce the IOCs' [International Oil Companies'] perception of risk they will be prepared to give you an even bigger share of the reward. OR, to put it another way: Offering a stable, consistent and predictable

---

receive \$1000 if B can toss a coin and get heads 5 times in a row. The odds of this occurring are 1 in 32 (i.e., 0.55). The risk-weighted value of this is  $1/32 \times \$1000$  or just over \$31. This is therefore what A can expect B to pay for this contract right. Suppose after B has obtained 4 heads in a row, it wishes to "cash out" and offers to sell its rights to C. The odds at this point of realizing the \$1000 payment have increased from  $1/32$  to one in two, and the value of the "contract" has increased from \$31 to \$500. To say that B is being "over-compensated" since he paid only \$31 for the contract rights, which now have a \$500 value, is simply not correct since it ignores all of the risks taken by B up to that point. A was fairly compensated for its sale and B is now fairly compensated as well. One can change this example to add a feature to the original contract such that, in the event B does obtain 5 heads in a row, in addition to the \$1000 it will receive, it will have a chance to receive an additional \$10,000 by rolling a dice and it coming up as a 6. The odds of getting the additional \$10,000 at the outset are  $1/192$  ( $1/32 \times 1/6$ ). The additional price B would pay A for this significant "upside," at the outset, would be \$52. But after B had achieved four heads in a row, the odds of the significant upside become  $1/12$ , with an expected value of \$833. This latter example could be viewed as similar to a case where an unexpected, or low probability but sustained upside in resource prices occurs well after the original contract date. The underlying economics of the contract would have built this in to the original expected value (as well as offsetting unexpected downsides).



tax environment, with a fair, transparent, timely and reliable appeals process is very valuable to IOCs. If you can convince them that you will provide this they will accept a higher government take.<sup>298</sup>

### ***Stability clauses***<sup>299</sup>

Investors frequently seek provisions in contracts that operate to limit the changes that can be made over time, most especially to the fiscal terms. This is because the projects generally involve substantial upfront capital and the project lives are expected to last for long periods. As noted, investors seek to reduce risks as much as possible, and given that government policies and officials will almost certainly change over time, a way to provide some degree of stability against such changes is often sought. “Stability” or “stabilization” provisions are common in natural resource contracts and are one of the mechanisms used to reduce political and legislative risks.

Stability clauses have themselves evolved over time. Most of the early clauses generally froze the important aspects of the fiscal and

---

<sup>298</sup> Bill Page, *Petroleum Tax Administration in EAC Countries: A Private Sector Perspective*. Paper presented at Fiscal Management of Oil and Natural Gas in East Africa—East African Community and International Monetary Fund Workshop, 15–17 January 2014, Arusha, Tanzania. Workshop materials available at <https://www.imf.org/external/np/seminars/eng/2014/eac/pdf/031514.pdf>, pp. 132, 137.

<sup>299</sup> A number of helpful articles and sources deal with stability clauses and related issues. For example, see Michael Polkinghorn, *Stabilization Clauses And Periodic Review Outline*, available at [http://www.energycharter.org/fileadmin/DocumentsMedia/Events/CCNG\\_2015\\_Michael\\_Polkinghorne.pdf](http://www.energycharter.org/fileadmin/DocumentsMedia/Events/CCNG_2015_Michael_Polkinghorne.pdf); Carole Nahkle, *Fiscal Stabilization in Oil and Gas Contracts – Evidence and Implications*, available at <https://www.oxfordenergy.org/publications/fiscal-stabilization-in-oil-and-gas-contracts-evidence-and-implications/>; Oyewunmi, Tade, *Stabilisation and Renegotiation Clauses in Production Sharing Contracts: Examining the Problems and Key Issues* (2011). Oil, Gas & Energy Law Intelligence Journal (OGEL) 2011, Vol. 9 - issue 6 pg. 1–25. Available at SSRN: <https://ssrn.com/abstract=2776677>; and Philip Daniel and Emil M. Sunley, “Contractual assurances of fiscal stability,” in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*, eds. Philip Daniel, Michael Keen and Charles McPherson (New York: Routledge, 2010) p. 405.

legal regime applicable to the particular project to what was, in effect, the contract that was agreed upon at the time. This provided investors with a higher degree of confidence that the important fiscal and other legal provisions upon which their economics were based would last throughout the project. A criticism of such “freezing” clauses is that they infringed on a country’s sovereignty to change its laws over time. In reality, such clauses did not technically prevent the government from enacting changes, but instead provided a contractual right to the investors that, should such changes be made, a contractual payment for “damages” would be due.

Nevertheless, clauses have generally evolved from the “freezing” type of provisions to ones more of an economic equivalence approach — hence many clauses now provide that should certain governmental changes occur (e.g., an increase in the tax rate) the parties agree to negotiate changes to the contract to place the investor back in the general economic position it would have experienced had the particular change in law not occurred. If the parties cannot successfully negotiate a change in the overall contract, in certain circumstances an investor may nevertheless be able to seek compensation based on the economic equivalence provision.

In some cases, the law itself can actually contain stability related provisions. For example, in South Africa fiscal stability is viewed as an important tool in facilitating future oil and gas investment (given the high costs of capital investment, combined with high risk and delayed potential profit). Current income tax law grants the Minister of Finance the power to enter into binding fiscal stability agreements with oil and gas companies. The predetermined terms were developed in a legislative process which allowed all interested parties to provide input and comments (including presentations to the Parliamentary Committee on Finance) and required written responses by the National Treasury.

A fiscal stability agreement concluded between the South African Minister of Finance and an oil and gas company in respect of an oil and gas right guarantees that the provisions of the Tenth Schedule to the Income Tax Act of 1962,<sup>300</sup> on the date of conclusion

---

<sup>300</sup>The fiscal stability provisions set out in paragraph 8 of the Tenth Schedule to the South African Income Tax Act of 1962 are as follows:

of the agreement, will continue to apply to the oil and gas right as long as the right is held by the oil and gas company. However, an oil and gas company may unilaterally terminate the agreement if so desired. The reason for termination could be that subsequent tax changes are more taxpayer favourable than the tax rates, deductions and rules applying on disposal of oil and gas rights, provided for in the Tenth Schedule on the date of conclusion of the agreement.

---

#### FISCAL STABILITY

8. (1) (a) The Minister may enter into a binding agreement with any oil and gas company in respect of an oil and gas right held by that company, and that agreement so entered into must guarantee that the provisions of this Schedule (as at the date on which the agreement was concluded) apply in respect of that right as long as the right is held by the oil and gas company.
- (2) (a) In the case of a disposal of an exploration right (...) an oil and gas company that has concluded an agreement as contemplated in subparagraph (1) in respect of that right may (...) assign all of its fiscal stability rights in terms of that agreement relating to the exploration right disposed of to any other oil and gas company.  
 (b) In the case of a disposal of a production right (...) an oil and gas company that has concluded an agreement as contemplated in subparagraph (1) in respect of that right disposed of may (...) assign all its fiscal stability rights in terms of that agreement relating to the production right disposed of to another company if that other company is a company within the same group of companies as the oil and gas company transferring the fiscal stability right at the time the agreement is concluded.
- (3) An oil and gas company that has concluded an agreement contemplated in subparagraph (1) in respect of an oil and gas right may at any time unilaterally terminate the agreement in respect of that oil and gas right so held with effect from the commencement of the year of assessment immediately following the notification date of the termination.
- (4) If the State fails to comply with the terms of the agreement contemplated in subparagraph (1) and that failure has a material adverse economic impact on the taxation of income or profits of the oil and gas company that is party to that agreement, that oil and gas company is entitled to compensation for the loss of market value caused by that failure (and interest at the prescribed rate calculated on the compensation from the date of non-compliance) or to an alternative remedy that otherwise eliminates the full impact of that failure.

It is likely that an investor will seek some form of a stabilization agreement, and each country must decide whether, and the degree to which, it is willing to provide such stability. South Africa and the Netherlands<sup>301</sup> have considered this issue and determined to provide some aspects of stability by means of statutory provisions. When implemented on a negotiated contract basis, the trend appears to be towards using economic equivalence types of provisions requiring a good faith negotiation between the parties. One other important technique that provides stability with respect to income- or profits-based taxes is a “pay-on-behalf” approach. Egypt provides a clear example of this since, under its production sharing contract (PSC) provisions, the governmental entity that is a party to the PSC makes income tax payments to the Government on behalf of the contractor.<sup>302</sup> The contractor, however, is still subject to the Egyptian income tax and continues to file its own tax return. Under the “pay-on-behalf” approach, the Government effectively withholds amounts due to the contractor equal to the contractor’s tax liability and remits such amounts to the Government, since these amounts are treated as additional taxable income to the contractor that must be reported on its Egyptian income tax return. Nevertheless, this contractual approach effectively insulates the investor from changes in the income tax laws with respect to the project.<sup>303</sup>

As noted, contractual stabilization provisions have to be evaluated in terms of their interrelationship with general statutory rules

---

<sup>301</sup> See article 55 of the Netherlands Mining Act.

<sup>302</sup> Egypt enacts into law each production sharing agreement, and thus the entire contract has the force of law and cannot be changed except with the approval of the Minister of Petroleum and the Parliament. See “Production Sharing Agreements: An Overview,” on the Egypt Oil and Gas Web Portal (March 2015) available from <http://www.egyptoil-gas.com/publications/production-sharing-agreements-overview/>.

<sup>303</sup> Ernst and Young, *Global Oil and Gas Tax Guide*, (2015). Available at [http://www.ey.com/Publication/vwLUAssets/EY-2015-Global-oil-and-gas-tax-guide/\\$FILE/EY-2015-Global-oil-and-gas-tax-guide.pdf](http://www.ey.com/Publication/vwLUAssets/EY-2015-Global-oil-and-gas-tax-guide/$FILE/EY-2015-Global-oil-and-gas-tax-guide.pdf). See also *Understanding Egypt: Production Sharing Contracts and Tax Barrels*, Apache Corporation (2014), available at [http://files.shareholder.com/downloads/APA/0x0x728759/af4015b8-478d-4506-a57c-7558d74b1a0a/Apache\\_Understanding\\_Egypt\\_20140226.pdf](http://files.shareholder.com/downloads/APA/0x0x728759/af4015b8-478d-4506-a57c-7558d74b1a0a/Apache_Understanding_Egypt_20140226.pdf).

in existence (or later enacted). The effect of such stabilization provisions may generally be more effective and more supportable as they apply to fiscal terms, versus human rights or other social issues, since they do not have to override the law (i.e., payments to the government can be made consistent with new rules followed by a contractual “reimbursement”).<sup>304</sup> Stabilization rules that apply to other conduct may not be as easily addressed, although in theory a monetary cost of the new rules or standards compared with those in effect at the date of the contract could be calculated, and thus compliance with the new standards would be achieved, but monetary offsets would be contractually provided, just as in the fiscal term example above. Nevertheless, many countries restrict the scope of stabilization provisions to fiscal matters, to avoid any concerns about their ability to change non-fiscal-related rules, and/or limit their duration.<sup>305</sup>

In administering stabilization provisions, it will be necessary to clearly understand how the parties view their operation in practice. For example, if the negotiators view the tax rules in effect at the time of the contract to be the ones that will govern actual payments to the government over the life of the project, this can place the tax administration in a clear conflict position. If the contract does not have the force of law in the country (sufficient to override other conflicting tax laws) tax administrators will be hard pressed to accept payments not based on the statute. The negotiators—on both sides—need to

---

<sup>304</sup> Regarding clauses that extend into areas of human rights, the United Nations Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, John Ruggie, addendum on principles for responsible contracts, provides that “[c]ontractual stabilization clauses, if used, should be carefully drafted so that any protections for investors against future changes in law do not interfere with the State’s bona fide efforts to implement laws, regulations or policies, in a nondiscriminatory manner, in order to meet its human rights obligations.” Available at <https://business-humanrights.org/sites/default/files/media/documents/ruggie/report-principles-for-responsible-contracts-25-may-2011.pdf>.

<sup>305</sup> Natural Resources Governance Institute, “Legal Framework: Navigating the Web of Laws and Contracts Governing Extractive Industries,” NRG Reader (March 2015), p. 6. Available from <http://www.resourcegovernance.org/analysis-tools/publications/primer-legal-framework>.

understand that they may not be able to “compel” this result, and in such cases, should mutually agree that they will address the financial impact of the changes by means of a contractual adjustment.<sup>306</sup>

Finally, if the stabilization provision operates to actually change or fix the law with respect to the project, the country will need to understand whether this may trigger “non-discrimination” provisions elsewhere in the country’s laws or treaties.

### *Parties involved from an investors standpoint*

In the mining industry, typically one investor is involved, while in the oil and gas industry it is common to have joint ventures, where several oil and gas companies participate. Where multiple investors are involved, they will usually nominate one as the lead negotiator, but all major participants are generally present, and even with those not present, or with other members of their teams, there is frequent and detailed consultation and communication. Whether one or multiple investors, the investor team will typically be led by their exploration and/or project development personnel, and will be supported by geologists, engineers, and other technical personnel. Other key participants will include financial (including tax) and legal representatives of the investor(s) both in-house and, often, outside advisors. Other support personnel (e.g., government and public affairs, health, safety, and environmental, or marketing groups) may be either included on the teams or consulted with on a regular basis.

Prior to and during negotiations, project planning (reserves, mining/drilling plans, infrastructure needs, etc.) and financial (costs, prices, markets, etc.) assumptions will be modelled and project economics will be developed on the basis of a number of scenarios. As negotiations proceed, investors generally rerun cases as new information becomes available or assumptions change. These economic evaluations, along with overall strategic and business judgment, are used to assist in the negotiations and in the ultimate determination of whether the investor will agree to undertake a particular project. Typically,

---

<sup>306</sup> Complicating this even further, of course, is the tax treatment of such an adjustment. If taxable itself under the country laws, the amount of the adjustment should be clarified as to whether it is to be “before” or “after” any country tax due.

investors have multiple investment opportunities and must evaluate each one on its own risk and return levels as well as in comparison with the other competing projects being considered.

Given the usually large commitments that are at stake, it is not uncommon for companies to use outside consultants to assist on a number of issues prior to and during the negotiations. This can be viewed as placing the country negotiators at a “knowledge” disadvantage, and approaches to dealing with this are suggested above in the section, on negotiation background.

## **Investment phases**

### ***Exploration***

In the exploration phase, minerals or oil and gas will generally be sought out by reconnaissance and seismic surveys. Contracts covering exploration will generally provide for a certain workplan, over a certain time frame and geographic area. The contractor will generally have the right to exploit the resource, if found in commercial quantities, subject to submission and approval of a development plan.

### ***Development***

After a feasibility study following exploration efforts, a development plan will generally be proposed and relevant government approvals will be required. In a contractual arrangement, the actual terms (including fiscal terms) may be negotiated in a context where the investor sets forth what it believes will be necessary for a commercial project to be viable, and the government will seek to maximize its benefits, consistent with a project going forward.

If there is the opportunity to negotiate a lower tax or royalty rate or any other payment to government, any rational company would take it. If there is an argument that the proposed arrangements in the model agreement are uneconomic, then a company would not be irrational to negotiate terms that made the mine economic under even the worst scenarios (though a forward-looking miner might be cautious about signing a deal that is “too good to be true”, anticipating government dissatisfaction and potential conflict down the road). The company

will want to make sure its...mine is still profitable after it has incurred the costs of getting the gold out of the ground, to market, and paid the government its shares.

But the government will want to be sure of some things as well. Its job is not to bend over backwards, but to maximize the total benefit to the country. Correction, the total NET benefit. This is a key concept. Mining comes at a cost.<sup>307</sup>

### ***Production/operations***

Once the facilities have been constructed or developed, including production, processing, and other infrastructure requirements, production operations will begin and production levels will be ramped up until production amounts set forth in the development plan are achieved (or levels are readjusted based on further agreement). The contract may call for some levels of minimum production to be required.

### ***Expansions***

Project expansions may be either envisioned in the contract itself, such as development in prescribed phases, or may be acknowledged as possibilities in the contract, and subject to approvals and possible expansion plan negotiations. Even where expansions have been envisioned, and where the expansion development plans have been set forth, it is possible that terms may need to be renegotiated to take into account new circumstances which either make a possible expansion uneconomic—such that it will not occur without modification—or make the terms to government unacceptable, given changes in assumptions upon which the original terms were set.

### ***End of project obligations***

The contract will also need to address the obligations of the contracting parties upon termination of the project. It is standard practice for contracts to require contractors—once mining or petroleum operations are no longer economic—to restore the affected properties to a suitable condition—e.g., removing production and processing structures and equipment and restoring the production site to an

---

<sup>307</sup> Mining Contracts, p. 50.



environmentally and ecologically stable and acceptable state. The general requirements for this “decommissioning” are typically covered in the contract (or licensing) terms. See Chapter 6 (the Tax Treatment of Decommissioning) for additional detail on this topic.

### **Some practical aspects of successful negotiations** <sup>308</sup>

Preparing for negotiations is a time-consuming process. Getting the negotiating process right is also time consuming. Both are essential, however, if the result is to be constructive. <sup>309</sup>

The following is a brief summary of some major practical considerations that can help achieve success:

- (i) Prepare and develop policy objectives before negotiations commence;
- (ii) Consider the long-term relationship and seek a result that is positive for the government, the community and the investor;
- (iii) Prepare by understanding the value of the resource and the economic development goals, including revenues, employment, infrastructure, downstream opportunities, local content, environmental stewardship, education and training;
- (iv) Build a negotiating team with interdepartmental representation and strong communication and decision-making protocols;
- (v) Carefully design mechanisms to ensure public outreach and involvement;
- (vi) Understand investor needs and objectives in order to identify and negotiate upon common interests;
- (vii) Obtain agreement on how to negotiate (place, language, timing, duration);
- (viii) Obtain agreement on what to negotiate (overall and in each session);
- (ix) Stay focused on objectives and avoid distractions;

---

<sup>308</sup> For additional background on this section, see the IISD Handbook, Parts 3 and 4, pp. 19–56.

<sup>309</sup> *Ibid.*, p. 56.

- (x) Develop strong team leadership and team discipline;
- (xi) Have political support for the negotiating team, including the ability to discontinue negotiations;
- (xii) Provide for public information and for community development agreement; and
- (xiii) Assume transparency of the ultimate contract as a means of ensuring community support and a long-term relationship focus.

## **Other contract negotiation issues**

### ***Due diligence in pre-negotiation research***

Before any negotiations begin, both the investor and the government will do research on one another, with the investor seeking to understand the goals and backgrounds of the governmental negotiators and information about the country, and countries equally seeking to understand the nature of the potential investor and its negotiators.

The term “due diligence” generally refers to an investigation carried out by a party to learn and verify the full background, history and current situation of the other party(ies) with which it may contract. Due diligence takes time and is expensive, but thorough due diligence will prevent and/or mitigate unwelcome surprises down the road. It is an essential tool in the decision-making process of any investor, financial institution or government.

Potential mineral investors will do due diligence on governments, to ascertain the stability of the government, and its political institutions to determine the political and economic risk of doing business in the country. Investors will also look at the stability and independence of the judicial system, the economic (debt) situation, the electoral situation, the human rights situation, and any other issues that could affect the profitability of an investment and the reputation of the investor.

Governments should do similar due diligence of potential investors to ascertain financial stability, expertise, experience, track record on environmental and human rights practices, history of

disputes and the like. Not all investors are equal. One would expect a government to do much less due diligence on a well-known international company with public financial statements and a long track record than it would on a little known privately held company. (...) [I]nvestigators will look for potential risks which could affect the company's ability to perform its obligations, such as the company's financial capacity to fund the mining project, its level of expertise and experience and its capacity to reimburse financing. Red flag items could be large unfunded reserves for potential losses, outstanding mass litigation such as asbestos or other product liability issues, ongoing criminal investigations concerning corruption, money laundering or other alleged crimes, allegations of human rights abuses or environmental neglect, and other reputational, financial or legal issues. If a red flag issue is identified, permission will often be requested to interview the company management, auditors and lawyers.<sup>310</sup>

The fiscal system of the country where the investor is located can have an impact on its negotiation positions. For example, companies residing in a country where relief from double taxation is granted by means of a foreign tax credit may have requirements for certain fiscal term characteristics that are different from those of companies residing in a country operating an exemption system. The investor's head office country of residence also determines whether such a company is able to claim the benefits of a treaty concluded between the country of source of income and the country of residence. Different tax treaty applicability can affect the relative positions of various investors. Finally, even greater differences may apply in the case of a state-owned investor competing against a private investor. Thus, based on these and other considerations, the economics of a transaction may look quite different between potential investors.

A final aspect of due diligence is understanding the nature of the contracting parties. The contracting party on the investor side may be a subsidiary of an investor incorporated in the host country, or of a company incorporated elsewhere and doing business in the host country via a branch. The country should seek to understand the nature of the investor, and the entire ownership chain leading to the ultimate

---

<sup>310</sup> Mining Contracts, pp. 179–80.

owner(s). This is particularly important when some type of performance guarantee may be required by the country from a company higher up in the chain of ownership. Investors will want to understand who the contracting party will be on behalf of the country, i.e., is it a Ministry of the country, a government-owned natural resources company, or a combination of both?

### *Transparency*

In countries that specify their natural resource rules by statute (e.g., the United States of America with respect to federal lands) the terms governing natural resource exploration and development are specified in law and regulations available to all, and successful bids are public. In these regimes, transparency regarding contract terms is complete, and applicable to all investors.

In countries that licence resources via private negotiations, the rules vary. In some countries, the law requires negotiated contracts to be approved by a legislative body, and hence the contract is generally, though not always, available. In other countries, the law requires that contracts (even if not subject to legislative approval) need to be made public as well.

However, a number of countries do not have requirements to make contracts available to the public, and while some may be, or become, public, this outcome is inconsistent. In some cases, the contracts are explicitly confidential and terms are not generally available to the public.

Increasingly there is a movement to publicize contracts, and organizations like the IMF, World Bank, Organisation for Economic Co-operation and Development and the Extractive Industries Transparency Initiative are generally in agreement that a best practice in promoting overall transparency, in addition to publishing financial information and payments made, is that final contracts relating to the extractive industries should be made publicly available.<sup>311</sup>

As noted earlier, a country will generally want to involve, via consultation at a minimum, outside groups at various stages of the negotiation process. This is an important element in obtaining support

---

<sup>311</sup> See <http://www.resourcegovernance.org/blog/takeaways-eiti-2016-contract-transparency-becoming-norm>.

for the process and the ultimate contract award, and ultimately can be viewed as increasing the overall “stability” of the contract itself.

Contracts negotiated by the Government often have tremendous impact on the life of communities affected by the operation of these agreements. In many developing countries, concession agreements also have nation-wide economic and social implications and can even affect state security. (...) Recognizing the impact of these concession agreements on Liberia, the Government committed to transparency by making the ArcelorMittal and Firestone agreements public documents. Contract transparency is in the best interest of the government, private investors and citizens. The disclosure of contracts expresses the public ownership of the exploited natural resources. Transparency also ensures that expectations from communities affected by the contracts are managed and realistic. Public disclosure of the terms of concession agreements provides a safeguard for private investors to ensure contract stability and avoid abuse in contract implementation. (...) <sup>312</sup>

Investors may prefer confidentiality to protect proprietary and competitive information and it is likely to streamline the process of finalizing an agreement, but their main objective appears to be that the rules be applied uniformly. Thus, rules that may apply only to certain types of investors (e.g., publicly traded companies) and thus treat competitors differently, can inappropriately provide a competitive advantage to some at the expense of others.

### ***Dispute resolution under a specific contract*** <sup>313</sup>

Given the number of issues that can arise under natural resource contracts, and the long timeframes of the projects governed by such

---

<sup>312</sup> Liberian Renegotiation Report, p. 62.

<sup>313</sup> Generally, a country will have established resolution procedures for tax disputes under its laws. However, a negotiated contract may provide for mechanisms to resolve other disputes that may arise in the interpretation of that contract. Where such contractual dispute resolution procedures cover items that are otherwise covered in a country’s statutes, they raise the same issues as discussed earlier with respect to possible conflicts which need to be clearly understood and addressed.

contracts, it is almost certain that disagreements on both the meaning of the contract terms and the compliance with the contract obligations (by either party) will arise. The contract itself generally provides mechanisms for resolving such disputes, with the ultimate resolution mechanism usually being litigation. However, there are often several steps that may be followed in resolving disputes other than by going to court:

- (i) Seeking to settle the dispute among the parties themselves;
- (ii) Referring the issue to a technical expert,<sup>314</sup> whose conclusion may be binding or simply advisory;
- (iii) Referring the issue for mediation (usually non-binding); and
- (iv) Referring the issue for arbitration (which may be binding or non-binding<sup>315</sup>).

In the context of reducing risks, investors often seek as the ultimate dispute resolution mechanism a binding arbitration approach under international arbitration rules.<sup>316</sup> A number of different international arbitration rules exist, under various international arbitration organizations, such as the United Nations Commission on International Trade Law (UNCITRAL), the London Court of International Arbitration, the International Chamber of Commerce, and the International Centre for Settlement of Investment Disputes.

---

<sup>314</sup> “Certain disputes that are of a more objective nature may lend themselves to expert determination, for example around the valuation of oil, where clear data are available from markets, and other accounting matters.” Oil Contracts, p. 182.

<sup>315</sup> See, as to “non-binding arbitration” which is most used in the United States and Canada: Steven C Bennett, “Non-binding Arbitration: An Introduction”, *Dispute Resolution Journal*, May-July 2006 at 1. Available at: <http://www.jonesday.com/files/publication/266ff349-03e1-4610-a7c1-6cd0f951e8bb/presentation/publicationattachment/1d047cae-3d31-4b6b-b280-71ed96efa8e5/bennett,%20steven%5B2%5D.pdf>.

<sup>316</sup> “Whilst host country citizens may find the suggestion that their courts are not impartial or fair somewhat insulting, the reality is that in many jurisdictions the court process may not be independent, or may be slow, and international investors generally...prefer not to take that risk.” Oil Contracts, p. 183.

It is important to note that even where international arbitration is invoked, and even if it is conducted outside the resource country, the governing substantive law under which the contract is to be interpreted, and which the arbitrators must apply, is most often the law of the resource country.

Where arbitration is not binding, the ultimate step for dispute resolution remains litigation, and generally under the courts of the resource country or a country agreed upon by the parties which otherwise may have jurisdictional rights.

Dispute resolution that extends beyond the parties themselves tends to be expensive and time consuming. Each party takes the “dispute resolution risk” regarding the ultimate outcome. Hence, by far the preferred dispute resolution mechanism is for the parties to settle the issue or issues via mutual agreement.

### ***Applicable law—domestic and international agreements***

Whether in arbitration or litigation, the law to be applied in resolving a particular conflict is most often the law of the resource country.<sup>317</sup> But the laws of the resource country, in addition to including any constitutional provisions and other statutory or similar laws applicable to the investor(s) and the project operations, may also include bilateral or multilateral tax and/or investment treaties. How such treaties interact with the other laws of the country can be very important, since they can in effect limit or even override what otherwise is the domestic law.

Further, in the negotiation of such tax or investment treaties, just as in the negotiation of resource contracts, again all affected departments within the government should be involved to avoid overriding domestic law without full consideration of the consequences. In some cases, it has been noted that those negotiating investment

---

<sup>317</sup> In purely contractual arrangements, it may be possible for the contract rights to be adjudicated based on laws other than those of the resource country, assuming all parties agree. Further, it would be possible, in an agreement with the country and ratified or passed by the body that has legal authority to make law within the country, to adopt laws governing the particular contract arrangement based on laws of other countries.

treaties have sought to use that mechanism to alter tax laws (including tax treaties) and practices, contrary to the policies and positions of the tax administrations. One example of this is where tax disputes are to be resolved by administrative review, and ultimately litigation, under domestic law, but an international investment treaty changes this to an arbitration approach.

Extracted below is an excerpt from a relevant Parliamentary Briefing from the Natural Resource Governance Institute.

### **Achieving a Good Deal: Fiscal Regimes for Oil, Gas and Mining** <sup>318</sup>

When designing or assessing fiscal regimes for oil, gas, and mining, government officials should take into account the following goals:

- **Fiscal regimes need to create sufficient incentives for private companies to invest.** Extractive projects have large upfront exploration and development costs and long production timelines. The fiscal regime must assure companies that the rules will not be unduly changed once investments are made. Stable fiscal regimes that provide a fair return to both investors and the state<sup>319</sup> under a variety of circumstances will be less likely to attract pressure for renegotiation.
- **Fiscal regimes should divide risk appropriately between the investor and the state.** Uncertainty is inherent in the extractive sector. The fiscal regime should ensure that the state does not end up bearing a share of risk disproportionate to its expected return.
- **The state should be compensated for the loss of resources, regardless of the profitability of a given operation.** This is because oil, gas and mineral resources are finite. Fiscal

---

<sup>318</sup> Natural Resource Governance Institute, Parliamentary Briefing. Available at [http://www.resourcegovernance.org/sites/default/files/nrgi\\_FiscalRegime\\_20150311.pdf](http://www.resourcegovernance.org/sites/default/files/nrgi_FiscalRegime_20150311.pdf), 2015. Underlined provisions have direct relationship to negotiation of contracts.

<sup>319</sup> For clarity purposes, note that references in this document to “state” are to the overall country involved rather than to any regional or local subdivision.



instruments such as baseline royalties provide a guaranteed return for the state even if a project runs losses.

- **Fiscal regimes should be progressive.** Extractive projects can generate substantial rents. Rents (sometimes called “windfalls”) are the financial returns above those a company requires to make the investment profitable. Mechanisms to measure and tax a share of windfalls can enhance state returns in times of high profits and adjust to allow for adequate company returns during times of low profits.
- **Countries should set fiscal instruments through laws rather than individual contracts.** Negotiated rather than standardized fiscal regimes are prevalent in the extractive sector. Setting fiscal regimes through laws increases transparency and accountability, because contracts are more likely to be kept secret. Also, negotiations bring additional opportunities for corruption or manipulation. Additionally, if the applicable fiscal regime varies from contract to contract, it can make monitoring onerous and frustrate the efforts of policymakers to carry out policy reforms.
- **Transparency and consistency can help strengthen the state’s position.** The extractive industries are characterized by significant asymmetries between states and private actors. Companies often have more information about the specific parameters of extractive projects and are more sophisticated in tax planning, which can give them the upper hand in negotiations.

## Contract renegotiation issues

### *Background*

Ideally, contract or licensing rules applicable to long-term natural resource projects will be flexible enough to “self-adjust” as circumstances change.<sup>320</sup> For example, in times of increased prices, fiscal terms that automatically adjust the amount of government take per a prescribed formula can ensure that a fair revenue sharing occurs,

---

<sup>320</sup> As noted, in addition to those providing for self-adjustment mechanisms, agreements that from the outset also reflect a fair balance of interests are less likely to generate a need for renegotiation.

even as total revenues increase. Conversely, in times of very low prices or increased costs, ideally the terms will adjust to promote continued operation of the project rather than making it even less economic. Thinking through items (or assumptions) that may change significantly over time and providing flexibility in the design of contract terms (such that potential changes may automatically be accounted for in the contract) can obviate the need for a “renegotiation” to occur.

Prior sections noted the use of stability clauses to address law or government policy changes. The more modern stability clauses call for the parties to enter into good faith negotiations to place the investor in a similar economic position as if the rules had not changed. This can be viewed as a means of acknowledging the right of the government to change its laws over time, while still protecting the economic interests of the investor and reducing its risks. This also, however, provides an obligation in effect to renegotiate terms in good faith.

In addition to renegotiations that may be implicated as a result of stability clauses, contracts also may have renegotiation clauses *per se* that can be invoked under circumstances specifically or more generally described in the clause. For example, an exploration and development agreement that covers oil may sometimes not cover natural gas, and thus may explicitly require that in the event that commercial quantities of natural gas are found, a new negotiation will take place regarding the terms of its development. More generally, some contracts may provide for “re-opening” certain provisions in the event of exceptional, unforeseeable or profound changes in circumstances. For example, an oil contract from Liberia provides:

The State and the Contractor shall meet if the State or the Contractor gives at least forty-five (45) days’ Notice to the other that it reasonably considers a Profound Change in Circumstances to have occurred. At the meeting, the State and the Contractor shall review the relevant facts and circumstances and determine whether or not a Profound Change in Circumstances has occurred. To the extent that a Profound Change in Circumstances has occurred, the State and the Contractor shall enter into good faith discussions to consider and shall make such modifications to this Contract as they may through good faith discussions propose as necessary

or appropriate to restore the economic, fiscal and financial balance of the Contract. (...) <sup>321</sup>

Increasingly, clauses explicitly recognizing the right to renegotiate contracts have become more prevalent. Given the long-term nature and complexity of issues involved in these contracts, it is highly likely that significant changes in circumstances will occur sometime during their existence. Assuming adjustments have not been built into the contract to cover these particular changes, the parties can address these in a number of ways:

- (i) The investor or the government can argue that a contract must be complied with, and the other party (the one seeking a modification) has no recourse but to abide by the original contract terms;
- (ii) The government (but not the investor) can impose changes on a take-it-or-leave-it-basis, which, in the worst-case scenario, can lead to an expropriation if the investor does not agree; or
- (iii) The parties can come together, recognize that under certain circumstances some modifications to the original contract may be appropriate, and negotiate in good faith to achieve an agreed solution.

Obviously, the third approach is best in terms of achieving an ongoing, mutually beneficial relationship. But political changes, public perception pressures, or even prior history can force an outcome under the first and second items above. Special circumstances calling for renegotiation of contracts can occur in post-conflict situations, where of course the nature and level of risks accepted at the time of the original agreement have changed substantially. <sup>322</sup>

---

<sup>321</sup> Jacky Mandelbaum, Salli Anne Swartz and John Hauert, *Periodic review in natural resource contracts*, Columbia Center for Sustainable Investment Briefing Note 1, June 2014, p.10. Available at <http://ccsi.columbia.edu/files/2014/08/Periodic-review-in-natural-resource-contracts-Briefing-Note-FINAL-8.11.pdf>.

<sup>322</sup> Phillippe Le Billon, "Contract renegotiation and asset recovery in post-conflict settings," in *High-Value Natural Resources and Peacebuilding*, eds. P. Lujala and S. A. Rustad (London: Earthscan, 2012). Available at <http://www.earthscan.com>.

The consequences of the first choice are obviously not helpful to a long-term, sustained relationship. What may be an advantage taken by one party (e.g., where the investor fails to work with the government in times of unexpectedly favourable conditions) can later become a disadvantage (e.g., where costs rise or prices drop for a prolonged period) and there will be little “sympathy” given the prior position taken.

Where the government has the upper hand, choosing either the first or second option can lead to an outcome where the resource becomes unproductive, with the result that the project is either mothballed or terminated prematurely. For example, where conditions change to the detriment of the investor, such as a long-term decrease in prices or highly escalating costs of meeting commitments, it may seek some relief from the government.<sup>323</sup> Where relief is not provided, the investor will nevertheless be obligated to fulfil its contract terms. But if the project is in its early stages, one could expect the investor to do the minimum required under the project terms, or even exercise a contract right to terminate. This may not be in the best interests of either party, and hence it is usually better to find some way to make adjustments—as long as they are reasonable and balanced. An investor requesting a delay in meeting drilling commitments (to mitigate a spike in drilling costs) could perhaps be granted that by the government in return for a small delay payment. Thus, a true negotiation, with each side giving and getting something, takes place.

On the other hand, when the government approaches an investor to renegotiate contract terms, the investor who is likewise interested in promoting and growing a long-term relationship, should likewise be open to a negotiation where each side gives and gets something. For example, an investor might agree on the renegotiation of a particular fiscal term sought by the government in return for a modification to the duration of the contract.

---

[ps://environmentalpeacebuilding.org/assets/Documents/LibraryItem\\_000\\_Doc\\_087.pdf](ps://environmentalpeacebuilding.org/assets/Documents/LibraryItem_000_Doc_087.pdf).

<sup>323</sup> It is not only countries that desire to renegotiate contracts; investors also seek modifications.

**Case studies**<sup>324</sup>

**Case A.** As referenced earlier in this note, extensive analysis has been done of Liberia's renegotiation of a number of resource contracts following the end of the civil war in 2003. Following her government coming to power in 2006, President Ellen Johnson Sirleaf ordered a review of all concession agreements, with priority given to the two largest, one with ArcelorMittal and the other with Firestone.<sup>325</sup>

When approached pragmatically, contract reviews and concession negotiation can benefit both government and industry. The amended Liberian contracts offer significant gains for the state and for the communities where Firestone and ArcelorMittal operate. The new agreements also pose no threat to the companies' profitability, and pave the way for a more stable partnership between the companies and the Liberian government. ArcelorMittal's decision to increase investment in Liberia by half a billion dollars shows plainly that better contractual terms and heightened investor interest can in fact go hand in hand.

The ArcelorMittal amended agreement had some 30 improvements over the original contract; the Firestone amendment had nearly 40 improvements. (...) The Government has widely cited the re-negotiations of the ArcelorMittal and Firestone contracts as proof of investor confidence that Liberia is "re-opened for business."

---

<sup>324</sup> Case A is based upon Liberia's post-conflict contract renegotiations. Cases B, C, and D are not country specific, but reflect factual elements in each case that were present in several countries.

<sup>325</sup> For an extensive report on the negotiations process and results, see Raja Kaul and Antoine Heuty with Alvina Norman, "Getting a Better Deal from the Extractive Sector—Concession Negotiation," in Liberia, 2006–2008; *A report to the Liberian Reconstruction and Development Committee Office of the President, Republic of Liberia* (New York: Revenue Watch Institute, 2009). It is worth emphasizing this case as a post-conflict transition to a democratic regime and that given the history involved and the vast changes in circumstances both inside the country and in the overall markets, the likelihood for a successful renegotiation was increased. Further, renegotiation in a transitional context may receive greater support from a country's "international partners" which can have a significant impact.

Liberia's successful negotiations with ArcelorMittal and Firestone have caught the attention of other African governments seeking to maximize value from concession agreements covering their natural resources.<sup>326</sup>

The report provides extensive background on how the negotiations were conducted, and the give and take that ensued, ultimately arriving at agreements accepted by the parties. It shows how a principled approach to renegotiations, coupled with a sound justification underpinning them, with strong preparation, technical assistance, and political support, led to a successful result.

**Case B.** In several countries, major natural resource discoveries have been made but development agreements and terms have yet to be finalized.

Oil-related contracts previously in place were renegotiated when natural gas was discovered to reflect the different economic and infrastructure requirements for that resource. Disputes have arisen as to whether the country negotiated sound revised contracts. Even where independent evaluations of the revisions supported the contract terms, public opposition continued because of the higher costs and risks associated with new production.

Given the uncertainties with respect to the renegotiated arrangements, as well as additional negotiations for new projects, finalization of terms continues to be delayed. An additional delay in the finalization of all contracts has been caused by the fact that several of the contracts have different terms, and there is now a desire to conform them all. In the meantime, investments that could have been started are on hold.

This case illustrates two important issues. First is the need to address public expectations and for the negotiators to explain the contracts they negotiate and defend their provisions.<sup>327</sup> With that,

---

<sup>326</sup> Liberian Renegotiation Report, pp. 1–2.

<sup>327</sup> This underscores the importance of involving the public via consultations and dialogue throughout the process and providing for appropriate regional and local support in the agreement or in separate agreements (such as community development agreements).

there will no doubt still be some opposition, but without that, the opposition can be based on inaccuracies and speculation.

The second issue is that negotiating separate terms for separate contracts can become a problem. In this case, the country has determined—after the fact in some instances—to try to combine parts of the projects and is now seeking to conform the terms. This effectively creates a renegotiation of several contracts, further delaying progress.

**Case C.** A country's reaction to dissatisfaction with the amount and pace of revenues coming into the Government during years of large price increases led to new taxes being imposed on the industry, and the obligation of existing contract holders either to sign new contracts or face expropriation.

A key element of the Government's approach was, despite the threat of expropriation, to offer attractive terms even after its new rules were imposed. In the end, most investors did in fact sign new agreements. Showing its flexibility, in light of a subsequent downturn in prices and the need for additional investment, the Government relaxed some rules and announced some new investment incentives for domestic and foreign investors.

This case illustrates that even in a rather extreme case—involving the threat of expropriation—, negotiating by still providing investors with what they needed (i.e., an attractive return based on the risks they had taken) resulted in most of them staying and even re-investing in the country. One factor that assisted in this outcome was that both parties benefitted from higher commodity prices following the renegotiations. But when prices dropped, the country understood future investment would be hampered by the changed circumstances, and reacted accordingly.

**Case D.** In some cases, the results of expropriation threats or actions do not end as well as in Case C, and more companies decide not to renegotiate. In this case, while some important investors did renegotiate, other significant investors did not, and the amount of new investment decreased. Further nationalizations were undertaken. Finally, after a number of years and in order to stem the investment declines, more favourable terms were provided and some new investment began to be committed.

This case illustrates that, where a government appears to “overshoot” the balance and imposes terms that may be too onerous, there is an increased risk that it could be counterproductive to its long-term goals. In the end, promoting policies and an atmosphere that suggest the desire for, and support the possibility of, a long-term relationship between investors and the country creates a higher chance of attracting, and sustaining, the investments that are critical to natural resource developments.

Each of the cases above, except for Case B, which is still in essence a work in progress, involved a degree of unilateralism on the part of the government. But in Case A, a true renegotiation took place and the basis for the renegotiation was a substantial change in circumstances compared with those underlying the original contracts. In Case C, fair compensation and a desire for an ongoing relationship (coupled with the fortuitous timing of the events which allowed both parties to gain from the significant price increases following the changes) provided confidence that ongoing investments were still justified. In Case D, the terms of the renegotiations, coupled with additional nationalizations in other industries, resulted in a real aversion to continued investments.

One might conclude that renegotiations (even those in the context of a partial ownership level change), if based upon real changes in circumstances and in an environment where the government makes it clear it still desires a positive although changed ongoing relationship, can be successful and can avoid or at least reduce collateral downside effects. But where done in a less constructive manner, they can stifle ongoing investment and ultimately be counterproductive.

### ***Consequences on specific projects—unilateral or negotiated adjustments***

If all or a part of a particular project is “expropriated” or nationalized, there can be obvious implications on continuing project investments and operations. Where the private investors are completely removed, the government must be comfortable that it can take over the management and operations, and provide the funding necessary for capital and operating needs.

If the government feels there are benefits to continuing outside investor participation, e.g., to provide funding or technical expertise,



it will need to consider this in how it effects its changes. If changes are unilaterally imposed, it is likely that investors (whether the original or replacements) will be more cautious, or seek additional new protections, before investing, since they will perceive the risks as having increased. This can lead to significant delays in project development. In addition, there are potential direct financial implications to the government, such as where an investor invokes an arbitration provision. Where changes are negotiated, and some “give and take” is provided, even where on an overall basis the terms become more favourable to the government, there is a strong likelihood that the relationship will not be unduly harmed, and that a positive and mutually reinforcing partnership may result from it.

Similarly, an investor who is faced with a unilateral, or negotiated, contract change to a project needs to determine the project’s long-term goals and act accordingly. If it also seeks a positive, long-term relationship, it needs to negotiate (or, in a unilateral change, react) in a positive and constructive manner. If it concludes that the best it can achieve is an exit, with compensation, then it needs to be prepared for a prolonged dispute over valuation, likely in a highly adversarial context.

### ***Consequences on other investments—unilateral or negotiated adjustments***

The actions of a government with respect to one project can have spill-over effects on other existing, or proposed, projects and investments. Thus, other current and prospective investors will be keenly interested in, and will closely follow, how any particular contract renegotiation (or nationalization) proceeds. Just as with respect to the project itself, the ability to achieve long-term private sector investment will be impacted by how the government approaches any specific project renegotiation. Where changes are unilaterally imposed, without consultation or ongoing discussion, other investors will view events with apprehension, which could reduce or delay additional investments in the natural resources sector or more broadly within the country. Further, the costs of future projects may increase due to a perception of an overall increase in country-related risks. Conversely, where the renegotiation is principle-based and proceeds fairly, such factors can greatly mitigate the otherwise negative collateral effects of a project renegotiation.

### *Changes in overall tax law in licence or contract countries*

Finally, while this chapter has focused on negotiations and renegotiations of natural resource contracts, many countries rules are set forth in law and licensing procedures, rather than being individually negotiated. In this context, unilateral changes are equally possible, by a mere change in the laws themselves. For example, countries like Norway and the United Kingdom put new excess profit taxes in place back in the 1970s in light of increased crude oil prices.

While there is almost always some degree of consultation with affected taxpayers at the time new legislation is proposed, the ultimate decision is a unilateral one. Just as in contract situations, investors take note of these changes and react accordingly. In some cases, there may be effective-date relief or legislated “stability” clause provisions that may be helpful. But more frequently, the law changes are imposed and investors change behaviour by adjusting their operations and future investments, given that their economics have been altered. Maximizing consultation and, perhaps providing some offsetting relief to the investors can help to build or maintain an environment of mutual trust.

Ideally, as with contract situations, statutory provisions that will govern the large investments of the natural resources sector should be developed by anticipating and reflecting as many conditions as can reasonably be envisioned. If, for example, an excess profit tax is envisioned in high price environments, having one in place, even if current conditions do not trigger it, is by far a better course than imposing it later, after the fact.

### **Conclusions**

Some countries govern the development of their natural resources via published law and licensing rules. The licensing provisions will cover the terms of making resources available for exploration and development, and will normally also provide for full life cycle obligations that a licensee accepts, including decommissioning at the termination of the project life. Tax rules may be covered under the general tax laws, or specific laws or provisions applicable to natural resources.

Other countries govern the development of their natural resources with negotiations done on a project-by-project basis. Where

this occurs, there may be published model agreements covering the host of issues and obligations in a natural resource project. However, the final negotiations on a particular project may deviate from the model in a number of areas, including the fiscal terms and possibly some stability provisions.

Irrespective of whether a country uses a statutory or negotiated contract approach in structuring long-term natural resource investments, it is key that up-front and continuous involvement of the tax authorities be present. In designing statutory rules, tax policy and administration experts are essential participants in ensuring the tax rules ultimately adopted are consistent with sound tax policy and the priorities of the country, and are enforceable. Similarly, when fiscal rules are set in a negotiated contract approach, tax experts should also be involved to ensure that provisions of the contract do not conflict with existing laws or regulations, that the provisions are clearly understood by all, and that they can be implemented as intended.

Given their long-term nature, economic and political conditions are bound to change over the course of natural resource projects. A best practice is to address, in some form or another, as many of these possibilities as can be envisioned at the beginning of the investment relationship; some can be handled by designing laws and licensing rules, or specific negotiated contracts, with as much flexibility and as many self-executing adjustments as can be developed to minimize disputes.

Nevertheless, it is not likely that all of the possible scenarios that may arise can be anticipated, and thus mechanisms to deal with such circumstances will need to be developed. Appropriately structured stability clauses may be one way to deal with changes in circumstances, but they tend to cover only some of the possible events. Re-opener or renegotiation clauses can be useful, and they can at least provide some general conditions that serve as trigger events for either party to seek contract adjustments. Since these may provide at most an agreement to negotiate in good faith, they do not in themselves compel or guarantee a result, but they can provide an expectation and a framework supportive of a mutually beneficial, long-term relationship.

### ***A final note on confidentiality and transparency***

It is clear that openness and engagement of the entire community can help achieve buy-in and support for the ultimate contract negotiated. But this must be managed with care. At times, particularly when contract negotiations are proceeding and proposals (and counter proposals) are being reviewed, confidentiality is crucial to the integrity and effectiveness of the process. When the negotiations are complete, however, it is incumbent on the negotiators to explain and defend the bases for their results. This is clearly the case when such agreements are subject to final review by outside groups or other governmental bodies before becoming effective. But even when that is not the case, presentations explaining the agreement terms and answering questions about them are equally important in order to gain public confidence and longer-term support, which benefit both governments and investors interested in positive, long-term relationships.

### **For more information**

*Mining Contracts—how to read and understand them.* Available at <https://s3.amazonaws.com/s3.documentcloud.org/documents/1279596/mining-contracts-how-to-read-and-understand-them.pdf>.

*Oil Contracts—how to read and understand them.* Available at <http://openoil.net/understanding-oil-contracts/>.

International Institute for Sustainable Development, *Handbook on Mining Contract Negotiations for Developing Countries, Volume One: Preparing for Success* (International Institute for Sustainable Development: Winnipeg, Manitoba, April 2015). Available at <http://www.iisd.org/sites/default/files/publications/iisd-handbook-mining-contract-negotiations-for-developing-countries-volume-1.pdf>.

Natural Resources Governance Institute. “Legal Framework: Navigating the Web of Laws and Contracts Governing Extractive Industries.” *NRGI Reader* (March 2015). Available at <http://www.resourcegovernance.org/analysis-tools/publications/primer-legal-framework>.

George Kahale, III, “The Uproar Surrounding Petroleum Contract Renegotiations.” *Oxford Energy Forum* (August 2010). Available at [http://www.curtis.com/siteFiles/AttorneyFiles/Oxford\\_Energy\\_Forum.pdf](http://www.curtis.com/siteFiles/AttorneyFiles/Oxford_Energy_Forum.pdf).

- EI SourceBook. Available at <http://www.eisourcebook.org/>. See in particular [http://www.eisourcebook.org/642\\_5PolicyLegalandContractualFramework.html](http://www.eisourcebook.org/642_5PolicyLegalandContractualFramework.html).
- International Monetary Fund, *Fiscal Regimes for Extractive Industries: Design and Implementation* (2012). Available at <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>.
- Environmental Law Alliance Worldwide, *Natural Resource Contracts: A Practical Guide* (2013). Available at [https://elaw.org/sites/default/files/images\\_content/general\\_page\\_images/publications/Natural\\_Resource\\_Contracts\\_Guide.pdf](https://elaw.org/sites/default/files/images_content/general_page_images/publications/Natural_Resource_Contracts_Guide.pdf).
- David Kienzler with the collaboration of Perrine Toledano, Sophie Thomashausen and Sam Szoke-Burke, *Natural Resource Contracts as a Tool for Managing the Mining Sector*. Federal Ministry for Economic Cooperation and Development (2015) Available at [https://www.bmz.de/g7/includes/Downloadarchiv/Natural\\_Resource\\_Contracts.pdf](https://www.bmz.de/g7/includes/Downloadarchiv/Natural_Resource_Contracts.pdf).
- Lisa E. Sachs, Perrine Toledano and Jacky Mandelbaum, with James Otto, *Impacts of Fiscal Reforms on Country Attractiveness: Learning from the Facts*. Available from [http://ccsi.columbia.edu/files/2013/11/Impacts\\_of\\_Fiscal\\_Reforms\\_on\\_country\\_attractiveness-Website1.pdf](http://ccsi.columbia.edu/files/2013/11/Impacts_of_Fiscal_Reforms_on_country_attractiveness-Website1.pdf).



## Chapter 9

### VALUE ADDED TAX

#### Executive summary

In the tax structure surrounding investment in the oil, gas and mining sectors, not enough systematic attention has been paid to the role of broad-based consumption taxes and their impact on the extractives industries. The value added tax (VAT) also commonly referred to as the goods and services tax (GST) is the broad-based consumption tax of choice in more than 160 countries worldwide, including those countries with large extractive industries.<sup>328</sup> Ideally, VAT should not operate differently for extractive industries as compared to any other industry. Developing countries with limited administrative capacity may however experience challenges in following this ideal, and may consider or have already implemented, alternative policy or administrative measures.

Due to their predominantly export-orientated nature, governments should not expect large amounts of VAT revenue from the extractive industries operating in their country. The VAT treatment of the extractive industries could, however, be a barrier to investment, which could ultimately lead to decreases in tax revenues from other taxes. There are also neutrality, efficiency and other potential costs to consider when deciding on the desired VAT system to apply to the extractive industries.

As VAT is applied to both extractive industry inputs and outputs—and also taking into account the long lead times in extractive industry investments—VAT affects the industry at every phase in its typical life cycle.

Both the exploration and development phases require considerable direct investment, with the development phase alone often

---

<sup>328</sup> One exception to this generalization is the United States of America which has no national level broad-based consumption tax, although most states have adopted retail sales taxes.

Table IX.1  
Value added tax in the life cycle of the extractive industries

| Life cycle phase                | Key activities undertaken <sup>a</sup>                                                                                                                                    | Input VAT deduction | Output VAT charged                                                            | Key issues                                                                                                                                                                                                                                                                                                  |
|---------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|-------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Exploration                     | <ul style="list-style-type: none"> <li>▪ Locating deposits;</li> <li>▪ Assessing commercial and economic viability; and</li> <li>▪ Typical 3 – 10 year period</li> </ul>  | Yes                 | No                                                                            | <ul style="list-style-type: none"> <li>▪ Surplus input VAT refunds due;</li> <li>▪ Opportunity cost on cash flow; and</li> <li>▪ Exposure to exchange rate depreciation</li> </ul>                                                                                                                          |
| Development                     | <ul style="list-style-type: none"> <li>▪ Preparation of site for production;</li> <li>▪ Establishment of infrastructure;</li> <li>▪ Typical 2 – 4 year period.</li> </ul> | Yes                 | No                                                                            | <ul style="list-style-type: none"> <li>▪ Surplus input VAT refunds due</li> <li>▪ Opportunity cost on cash flow</li> <li>▪ Exposure to exchange rate depreciation</li> </ul>                                                                                                                                |
| Production                      | <ul style="list-style-type: none"> <li>▪ Production and commercial processing</li> <li>▪ Typical 15 – 20+ year period</li> </ul>                                          | Yes                 | Yes — Often at a zero-rate as output is largely exported                      | <ul style="list-style-type: none"> <li>▪ Generally, 0% VAT on export of outputs;</li> <li>▪ Recovery of input VAT;</li> <li>▪ Opportunity cost on cash flow;</li> <li>▪ Exposure to exchange rate depreciation; and</li> <li>▪ Compliance costs for documentary requirements accompanying export</li> </ul> |
| Decommissioning /rehabilitation | <ul style="list-style-type: none"> <li>▪ Removal of infrastructure;</li> <li>▪ Restoration of site</li> </ul>                                                             | Yes                 | Limited amount and often zero-rated as output and infrastructure is exported. | <ul style="list-style-type: none"> <li>▪ Surplus input VAT refunds due</li> <li>▪ Opportunity cost on cash flow</li> <li>▪ Exposure to exchange rate depreciation</li> </ul>                                                                                                                                |

<sup>a</sup> These activities may take longer in practice than the typical period provided in this table.



accounting for 40 to 50 per cent of the total cost of the project.<sup>329</sup> Large capital goods are generally imported and other inputs are also imported or supplied by the local economy. During these periods there is no commercial production/sales of output. This means that extractive industries may have difficulty in being allowed to register for VAT and that there is little or no output VAT on domestic sales against which input VAT can be deducted. Therefore, input VAT refunds will arise that can only be claimed when registration is allowed.

The refund policy of the host country, thus, becomes critical to investment decisions as it affects the cash flow position of the investor and could become a cost to the investor. The delay of input VAT refunds can act as a barrier to investment during the exploration and development phases.<sup>330</sup> Further, the adopted VAT policy applicable to the extractive industries and related administration can have spillover effects into the local economy, whether positive as a result of increased economic activity or negative as a result of decreased economic activity or non-neutrality of treatment.

During the production phase, produced goods are often predominantly exported,<sup>331</sup> meaning the destination principle will apply to these exports — the destination principle allows for VAT only to be collected in the country of consumption of goods and services. This is achieved by zero-rating exports and charging import VAT on imports, so that in the case of exports during this phase, the supply<sup>332</sup>

---

<sup>329</sup> United Nations, “Extractive industries: optimizing value retention in host countries” in *The United Nations Conference on Trade and Development* (2012). Available at [http://unctad.xiii.org/en/SessionDocument/suc2012d1\\_en.pdf](http://unctad.xiii.org/en/SessionDocument/suc2012d1_en.pdf).

<sup>330</sup> It can also be argued that the timely refund of input VAT can create a competitive advantage to a country in relation to other potential investment countries.

<sup>331</sup> It should be noted that this is not always the case (e.g., in the case of gas in Brazil).

<sup>332</sup> Value added tax (VAT) is usually described as being imposed on “supplies” rather than “sales” of goods or services, since the term “supplies” includes sales as well as other forms of providing goods and services to a customer (refer to terms used).

will be zero-rated.<sup>333</sup> Due to the majority of output being exported and therefore zero-rated, the amount of output VAT against which input VAT can be deducted is limited, creating the need to obtain refunds of input VAT from the government. During this phase, the delay of input VAT refunds could create VAT policy and related administration challenges and be a barrier to investment.

During the decommissioning/rehabilitation phase, services that relate to decommissioning are often supplied by businesses in a different jurisdiction than that of the extractive site. This is as a result of an expert level of these services often not being obtainable in the country of the extractive site. Since production has ceased and generally few supplies are made during this phase, challenges regarding the refund of input VAT may again arise. This is because there is no output VAT against which input VAT (primarily on services) can be claimed, and extractive industries may be required to deregister for VAT purposes before completing the decommissioning/rehabilitation phase.

From an extractive industries perspective, the key issues to note therefore relate to:

- A stable, neutral and efficient VAT framework applicable to the industry;
- The timely recovery of input VAT, to (i) mitigate opportunity costs on cash flow, and (ii) protect against exchange rate depreciation which would erode the value of the refunds due;
- Being allowed to register before making any taxable supplies and not being forced to deregister during the decommissioning/rehabilitation phase; and
- Efficiency regarding the administrative requirements when exporting goods.

From a host country perspective, the key issues to note would relate to:

- A stable, neutral and efficient VAT framework ensuring that VAT refunds due are administered in a timely manner and minimize distortions;

---

<sup>333</sup> All countries with a VAT apply the destination principle. The destination principle ensures neutrality in trade and protects the legal base of the VAT (consumption).

- Demonstrating that the host country is a suitable location for long-term, stable investments;
- Developing the local economy as a result of the increased investment in the country;
- A robust set of rules relating to the tax treatment of decommissioning; and
- Limiting evasion under the VAT to the extent it applies to the extractive industry and industries supplying to this industry.

## **Purpose**

The purpose of this chapter is to provide an overview of VAT policy and administration measures that countries have implemented or could consider as they relate to the life cycle of the typical extractive industry activities. The potential impact on investment decisions and spillover effects into the local economy are also discussed. Place of supply and consumption rules, as they relate to the extractive industries, are also suggested.

This chapter is for information purposes only. It is intended to identify VAT issues related to the extractive industries and identify and discuss all potential policy and administrative initiatives that countries have implemented or could consider implementing. It should be understood that the discussion of a policy or administrative initiative does not mean that this initiative is recommended. On the contrary, some initiatives are not recommended, but are discussed since some countries have implemented these initiatives and others may consider doing so in the future.

## **VAT policy and administration in the extractive industries**

### *An overview of the VAT*

The VAT is a tax on final consumption of goods and services charged on value added at multiple stages of production. Table VII.2 illustrates this process.

From table VII.2 it can be seen that the total value added in the production-distribution chain (20,000) multiplied by the tax rate (10 per cent) is equal to the net amount received by government (2,000) which is paid by the consumer. This amount is, however, collected

from registered businesses in the production-distribution chain based on their value added. This is achieved by having registered suppliers charge output VAT on their supplies and allowing registered purchasers an input VAT deduction of the tax paid to the supplier. The tax is, therefore, not borne by registered businesses since the tax paid by them to their suppliers is either deducted or refunded (where their input VAT deductions exceed their output VAT charged).

Table IX.2:<sup>a</sup>

**Workings of a VAT** (assumed rate of 10 per cent)

| <b>Basic transactions, excluding VAT</b>             |                             |                               |
|------------------------------------------------------|-----------------------------|-------------------------------|
| <b>Production-distribution chain</b>                 | <b>Purchases</b>            | <b>Sales</b>                  |
| Producer                                             | 0                           | 4 000                         |
| Manufacturer                                         | 4 000                       | 12 000                        |
| Wholesaler                                           | 12 000                      | 14 000                        |
| Retailer                                             | 14 000                      | 20 000                        |
| Consumer                                             | 20 000                      | -                             |
| <b>VAT payments to suppliers and buyers</b>          |                             |                               |
| <b>Production-distribution chain</b>                 | <b>VAT paid to supplier</b> | <b>VAT paid by buyer</b>      |
| Producer                                             | 0                           | 400                           |
| Manufacturer                                         | 400                         | 1 200                         |
| Wholesaler                                           | 1 200                       | 1 400                         |
| Retailer                                             | 1 400                       | 2 000                         |
| Consumer                                             | 2 000                       | -                             |
| <b>Fractional collection of VAT paid by consumer</b> |                             |                               |
| <b>Distribution-production chain</b>                 | <b>Tax paid to supplier</b> | <b>Tax paid to government</b> |
| Consumer                                             | 2 000                       | -                             |
| Retailer                                             | 1 400                       | 600                           |
| Wholesaler                                           | 1 200                       | 200                           |
| Manufacturer                                         | 400                         | 800                           |
| Producer                                             | 0                           | 400                           |

<sup>a</sup> Adjusted from Sijbren Cnossen, "A VAT primer for lawyers, economists, and accountants," *Tax Notes* 124(7) (2009), p. 687–98.

An input VAT deduction is, however, only allowed if the registered purchaser will use the goods or services purchased to make taxable supplies (e.g., supplies that are charged with VAT). Since a consumer is a final recipient of the product (i.e., it does not make taxable supplies) no input VAT can be deducted by the consumer and the consumer pays all the tax. The consumer — as opposed to a producer — paying the VAT is central to ensuring the neutrality and economic efficiency<sup>334</sup> of the VAT.

A key feature of all VAT systems is the destination principle, which ensures neutrality in trade and protects the legal base of VAT. Neutrality in trade can be taken to mean that foreign businesses are not advantaged or disadvantaged in respect of the level of VAT applied to a supply of goods or services in a jurisdiction. As noted above, in essence, the destination principle allows for VAT only being collected in the country of consumption of goods and services. This is achieved by zero-rating exports and charging import VAT on imports. Table VII.3 illustrates the workings of the same transactions as in table IX.2, but where the manufacturer makes a zero-rated supply by exporting goods.

From Table IX.3 it can be seen that as a result of exporting the goods or services, the government receives no VAT revenue (400 – 400). It is further important to see that this will only be the case where the manufacturer is allowed to deduct input VAT on the VAT paid to the producer (400). Where the manufacturer makes other standard rated taxable supplies, this input VAT can be offset against those supplies. If, however, the manufacturer does not have sufficient supplies against which to offset the input VAT, the government needs to provide the manufacturer with a VAT refund. Failure to do so, or do so in a timely manner, results in many distortions (discussed later) and incorrectly taxes production rather than consumption.<sup>335</sup>

---

<sup>334</sup>For this purpose, economic efficiency means that the VAT does not influence the behaviours and decisions of producers.

<sup>335</sup>If a government does not plan on providing input VAT refunds to extractive industry suppliers, it should make that clear during negotiations. It should further understand that this is entirely inconsistent with the nature of a VAT and creates an entirely different type of cost.

Table IX.3:

**Basic transactions, excluding VAT**

| <b>Production-distribution chain</b>                 | <b>Purchases</b>            | <b>Sales</b>                                    |
|------------------------------------------------------|-----------------------------|-------------------------------------------------|
| Producer                                             | 0                           | 4 000                                           |
| Manufacturer                                         | 4 000                       | 12 000                                          |
| <b>VAT payments to suppliers and buyers</b>          |                             |                                                 |
| <b>Production-distribution chain</b>                 | <b>VAT paid to supplier</b> | <b>VAT paid by buyer</b>                        |
| Producer                                             | 0                           | 400                                             |
| Manufacturer                                         | 400                         | 0<br>(in country of origin)                     |
| <b>Fractional collection of VAT paid by consumer</b> |                             |                                                 |
| <b>Distribution-production chain</b>                 | <b>Tax paid to supplier</b> | <b>Tax paid to (tax refunded by) government</b> |
| Manufacturer                                         | 400                         | (400)                                           |
| Producer                                             | 0                           | 400                                             |

**VAT registration**

Due to the extensive periods during the exploration, development and decommissioning/ rehabilitation phases when extractive industries often do not make taxable supplies, registration issues may arise. Many countries impose a voluntary registration threshold, requiring suppliers to make taxable supplies in excess of a certain amount within, generally, a 12-month period before being able to register. There may also be other requirements that need to be met before allowing a supplier to register for VAT. Further, when a supplier no longer makes a sufficient amount<sup>336</sup> of taxable supplies, that supplier may be required to deregister.

It is important to note that an extractive industries supplier should be considered to be conducting a VAT enterprise from when, and for as long as, that supplier is involved in the activities of the enterprise. The classification as a “VAT enterprise” should not be artificially

---

<sup>336</sup> This is generally the amount of the voluntary registration threshold.

limited only to periods when it is making taxable supplies. In other words, an extractive industries supplier should be viewed as constituting a VAT enterprise during the whole life cycle of the business, including *all* the phases not only the production phase.

To enable an extractive industries supplier to deduct the input VAT and import VAT paid (and to claim a refund) the supplier should be allowed to register when its activities relating to the extractive industries commence (exploration phase) and should not be deregistered until after its activities cease. This means that the decommissioning/rehabilitation phase should be considered an integral part of the exploration venture, and the supplier should only be made to deregister after this phase is complete. Not doing so might result in an investor not being able to claim VAT refunds, or only being able to claim a VAT refund at a much later stage.

### ***Issues relating to VAT policy and administration in the extractive industries***

As a result of the destination principle, VAT should in theory have little impact on the extractive industries, since its supplies are generally exported. Further, due to its export orientation, government should not expect to raise much VAT revenue from this sector, as revenue is typically raised on domestic consumption. A government's revenue generation from the VAT is, therefore, limited to the amount of product consumed domestically. However, it is notable that, in practice, challenges with VAT remain — particularly in relation to refunds — as explained in this chapter.

The exploration and development stages do pose particular challenges for VAT; there is significant capital and other investment (input VAT including reverse charge on imports) but little or no production (output VAT). This ultimately creates a surplus input VAT position which, if not refunded in a timely fashion, will impact cash flow, foreign exchange fluctuations and associated investment decisions, ultimately affecting local content. <sup>337</sup>

---

<sup>337</sup> This is, of course, an issue in other industries besides the extractive industries.

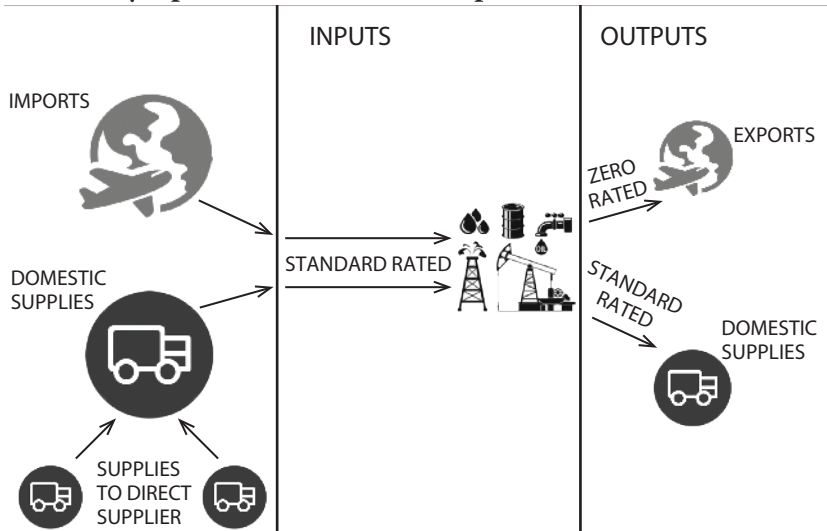
***VAT policy and administration options relating to the extractive industries***

*Full application of VAT*

Ideally, a VAT policy for the extractive industries should not be any different from the policy governing any other industry. The key focus should be an efficient and robust VAT framework, which favours government, as well as the investor, and does not leave the investor or government in a position where the payment of funds is delayed.

A standard rate of VAT is charged on all inputs, and corresponding outputs are charged at the standard VAT rate on domestic supplies and a zero-rate on exports. Excess input VAT would be refunded at the end of the requisite period. Extractive industries suppliers would be allowed to register at the exploration phase so that the typical VAT input/output mechanism would function. This approach would ensure that domestic consumption attracts VAT while production, once exported, would not attract VAT in that jurisdiction.

Figure IX.1:  
**VAT Policy Options: standard rated inputs**



Source: UN/DESA.

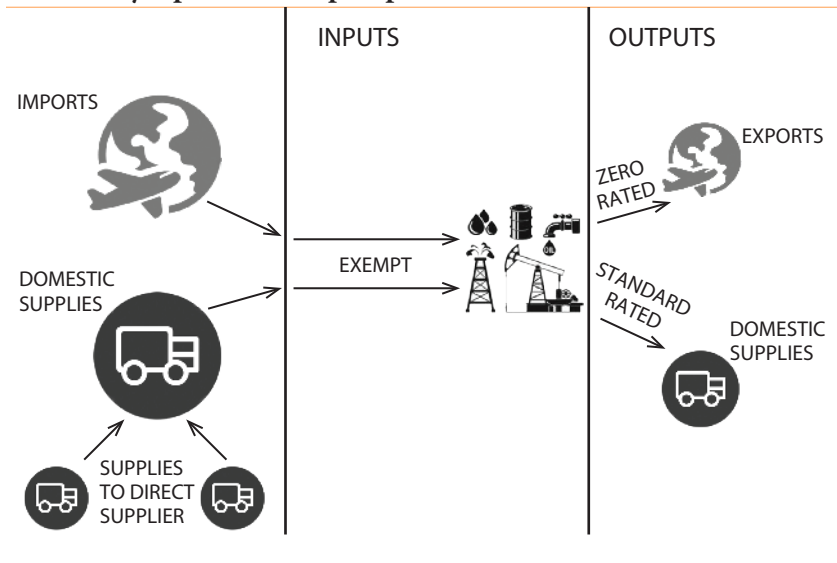


Although this best practice policy approach is ideal, unless there is a robust system that works to efficiently refund surplus input VAT, it may create cash flow issues for the extractive industries. The administrative requirements in successfully implementing this approach (specifically, the timely payment of VAT refunds) may suggest that alternative policies may be preferable for governments and investors. These alternative policies, together with their advantages and disadvantages are discussed in the remainder of this section.

*Exempt goods and services supplied to the extractive industries*

One approach to mitigate the issues regarding the timely payment of input VAT refunds is to exempt goods and services typically supplied to the extractive industries. This means that a careful selection of goods and services would be required to mitigate the risk of this exemption being used for goods and services not specific to the extractive industries. Strict audit and enforcement rules would also be required to limit the abusive use of these exemptions.

Figure IX.2:  
**VAT Policy Options: exempt inputs**



Source: UN/DESA.

In the case of imported exempt goods or services, import VAT would not be imposed meaning no entitlement to an input VAT deduction. Further, there would not be input VAT on specific locally sourced goods. The issues regarding the timely payment of input VAT refunds should, with this approach, be largely resolved.<sup>338</sup> It should be noted, however, that a full VAT exemption regime could result in economic distortions. Local suppliers to the extractives would continue to have input VAT on their inputs, which they would not be able to fully offset by charging output VAT on their supplies to the extractive industries. This may result in local suppliers attempting to pass such irrecoverable costs to the extractive industries. There would also be a theoretical risk of creating a pro-import bias in the sense that supplies imported free of VAT could ultimately be cheaper than local supplies with inflated prices. Such a consequence could negatively impact the local economy beyond the extractive industries.

Compliance burdens for local suppliers would further increase to the extent that they would be required for distinguishing between exempt supplies and standard-rated supplies. The local supplier would then be required to do an input VAT apportionment, which might give rise to significant compliance costs to the local supplier. The non-neutrality and the non-symmetrical compliance burden, and the accompanying economic distortions that result because of implementing the exemption, are most likely to constitute detriments that exceed the benefit of resolving the refund problem.

### *Zero-rated goods and services supplied to the extractive industries*

Another approach to avoiding the issues regarding the timely payment of input VAT refunds is to zero-rate the goods and services predominantly supplied to the extractive industries. Similar to the exemption regime discussed in the section on exempt goods and services, there is a high risk, especially in less developed economies, that the zero-rated goods and services would in practice not be used only by the extractive industries. This risk is likely to be higher under this option, when

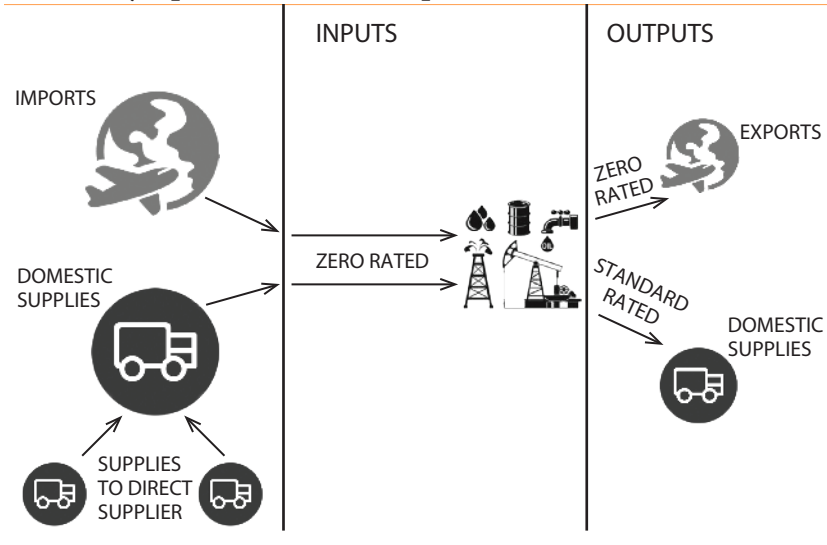
---

<sup>338</sup> It may be that there are certain types of goods or services used by many industries that are standard rated and an input VAT refund may still potentially arise. It can, however, be expected that this refund would be significantly less.

compared to the exemption regime, since locally sourced goods and services of these types would not be subjected to any VAT.

Figure IX.3:

**VAT Policy Options: zero-rated inputs**



Source: UN/DESA.

An issue to consider under this approach is that recovery of any input VAT would effectively be shifted towards suppliers to the extractive industries (they would ultimately be in a refund position). This means the accompanying issues in obtaining a VAT refund within a reasonable period are also shifted towards these suppliers. This would particularly occur in instances where the supplier was not making other standard-rated supplies.

In summary, the following issues are likely to arise when goods and services to the extractive industries are zero-rated or exempted:

- A decrease in the neutrality and economic efficiency of the VAT due to the differentiated treatment of goods;
- Non-symmetrical compliance burdens between local registered businesses and extractive industries suppliers;
- An increase in administration and compliance costs of the VAT, without any additional revenue being generated;

- A decrease in total revenue, due to goods that were previously standard rated and consumed by households, now being zero-rated or exempt;
- Bargaining to expand the goods that are zero-rated or exempt by extractive industries suppliers, or by other industries to obtain preferential treatment; and
- Increased opportunity for fraud and evasion.

### *Policies similar to selective zero rating of supplies to the extractive industries*

In attempting to resolve or address issues connected to the timely payment of VAT refunds, countries may adopt policies in the form of accounting measures that have a similar result to applying a selective zero rating of supplies to the extractive industries.<sup>339</sup> The purpose of such policies would be to promote the effective administration of VAT such that VAT refund positions, should they arise, would not be unduly delayed. Further, such policies would be expected to limit economic distortions and the possible risk of using zero-rated supplies in other industries besides the extractive industries.

### *VAT on imported services: application of the reverse charge*

A reverse charge mechanism provides that the responsibility for reporting a VAT transaction moves from the provider to the recipient of a good or service, with the latter required to report both their purchase (input VAT) and the supplier's sale (output VAT) in their VAT return.

The reverse charge could be applied to import services whereby the requirement to pay and later request a refund could be lifted. The extractives industries would be required to self-assess the amount of import VAT that needs to be paid. Similar approaches can be applied to the importation of goods.

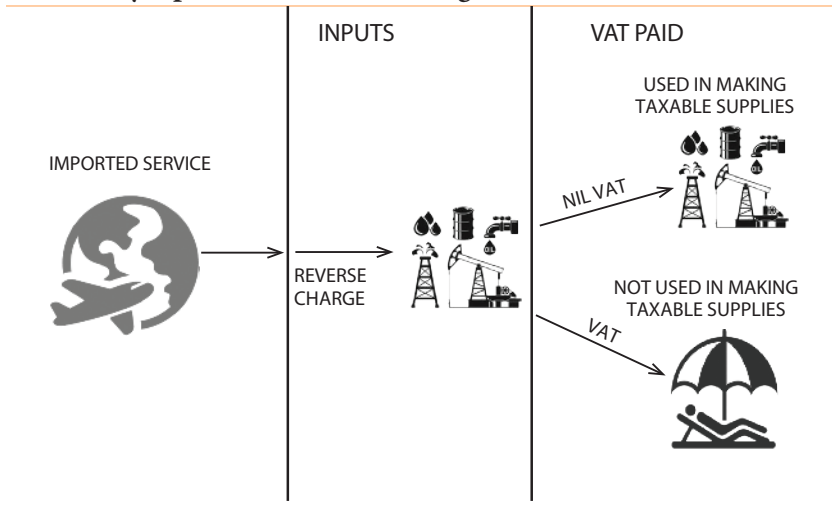
### *Deferral of VAT on imported goods: payment time lag*

A payment time lag would allow deferral of payment of import VAT for a specific period of time by not requiring import VAT upon importation,

---

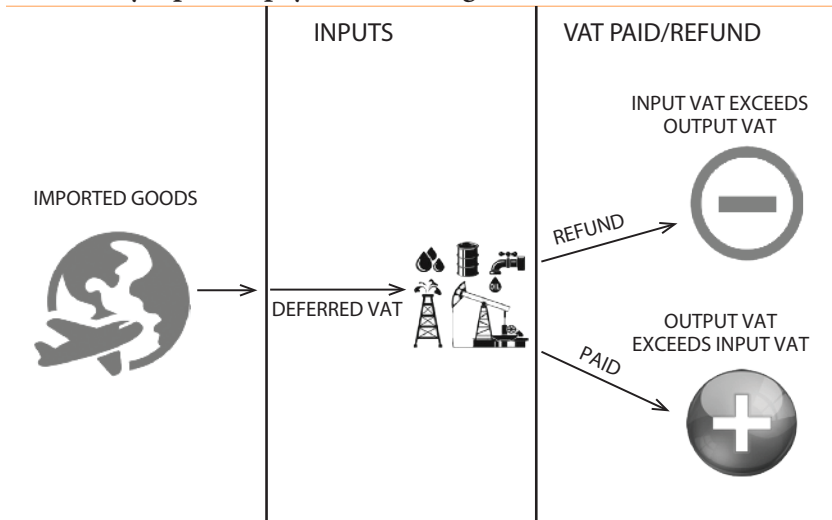
<sup>339</sup> All the approaches discussed below are currently implemented by at least one country in Europe.

Figure IX.4:  
**VAT Policy Options: the reverse charge mechanism**



Source: UN/DESA.

Figure IX.5:  
**VAT Policy Options: payment time lag**



Source: UN/DESA.

but providing for a payment of output VAT in a later VAT return. The aim of this approach is to allow registered suppliers to make taxable supplies from the use or supply of the imported goods for a limited time before ultimately being accountable to pay the VAT, thereby easing cash flow constraints. Ideally, this mechanism allows registered suppliers to charge output VAT and then account for the VAT on imports. It should be noted, however, that where the taxable supplies of the importer are zero-rated (as would often be the case in the extractive industries due to exporting their supplies) there would be no output VAT against which the input VAT deduction can be claimed and the issues regarding the timely payment of VAT refunds would remain. Further, if the period of deferral is too short, the cash flow issues would remain.

*Deferral of VAT on imported goods:  
accounting only, no payment*<sup>340</sup>

Another, perhaps more preferred, method of deferral of import VAT is to require the importing supplier to simply account for the import VAT on its VAT returns as an “in” and “out”. The supplier would show the import VAT as output VAT with an immediate input VAT deduction for the output VAT shown on the return, meaning that a net nil VAT position would arise on the importation of goods. This approach would, however, require robust administration and liaison between domestic tax collection services and customs services, and therefore might only be suitable for experienced tax administrations. Further, good tracking mechanisms would be required to ensure that only eligible items are included within the scope of this provision. It may also be possible to allow the deferral not on specific goods, but rather on all goods imported by a specific entity.<sup>341</sup>

*Exempt status to the extractive industries suppliers*

It would also be possible to provide exempt status in relation to certain imported goods to suppliers in the extractive industries. This

---

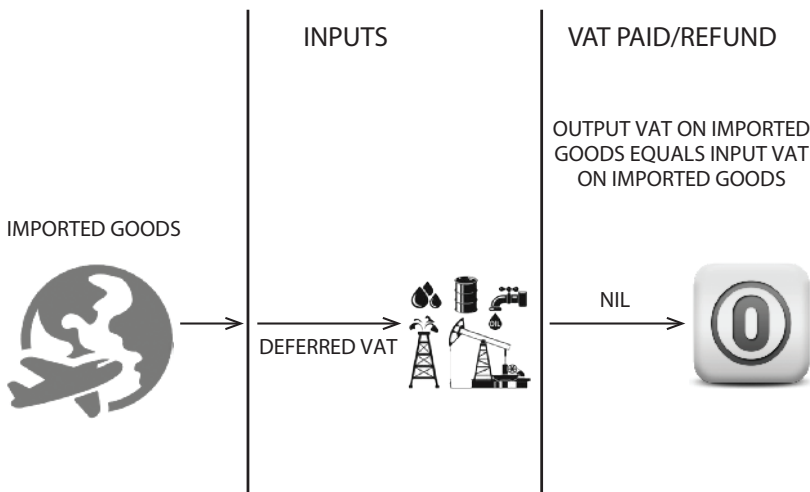
<sup>340</sup> This approach is currently adopted by the European Union for all supplies of goods between countries in the Union.

<sup>341</sup> It should be noted that for temporary importation of goods (typically for temporary extractive industry missions) alternative approaches may be preferred to defer the import VAT.

approach is therefore different to the one discussed in the section on exempt goods and services (above) as it does not involve a change in legislation. Upon the importation of those specific goods, a supplier would provide proof of its exempt status to the customs office to relieve the imposition of import VAT. There is, however, an obvious risk of fraud in this approach from importers who falsify their proof of exempt status or import goods under the exempt status of another supplier.<sup>342</sup>

Figure IX.6:

**VAT Policy Options: netting inputs and outputs**



Source: UN/DESA.

*Pure administrative approaches for the extractive industries*

It should be understood that the majority of issues regarding input VAT refunds to the extractive industries are administrative. These issues can be associated with compliance costs in claiming VAT refunds, administrative costs in auditing VAT refunds, sufficiently budgeting for VAT refunds, and the physical payment of VAT refunds.

<sup>342</sup> Similar risks of evasion that are present under a retail sales tax could arise under this approach. Goods may be removed from the VAT chain and it may be difficult to track this type of fraud.

If a country has the administrative capacity to resolve the issues arising from VAT refunds by administrative measures (rather than policy or accounting) the following administrative approaches could be implemented:

- (i) Review of the documentation required to claim an input VAT refund as well as the time it takes suppliers to prepare and submit applications for input VAT refunds and attempt to decrease these documentary requirements. The risk of fraud should also be considered in this process;
- (ii) Implementing a risk-based approach to VAT administration which could see targeted audits and potentially more refunds being paid and with less delay:
  - a. Following a risk channeling approach (often referred to as a “green and red channel” approach<sup>343</sup>) that could assist tax compliant suppliers (“green channel”) receiving refunds in a timely manner. This could further provide an incentive for “red channel” taxpayers towards increasing compliance in an attempt to be moved to the “green channel”. The only significant issue with risk channeling is that the treatment of established and newer VAT suppliers may not be neutral and may favour established VAT suppliers. However, this can also be an effective benefit to government, since new vendors will have an incentive to demonstrate their compliance with VAT requirements as soon as possible;
  - b. Post VAT refund audits for lower risk refund claims, meaning that such refunds can be paid more often and with less delay;
- (iii) In budgeting for input VAT refunds, refund forecasting and monitoring tools could play an important role in ensuring sufficient funds are allocated and made available to pay refunds. Such tools would forecast the expected amount of refunds that need to be budgeted for, based on patterns of past refund claims. A dedicated VAT refund account at the Central Bank of a country may also address cash flow

---

<sup>343</sup>This is also sometimes referred to as the “gold and silver status” approach.

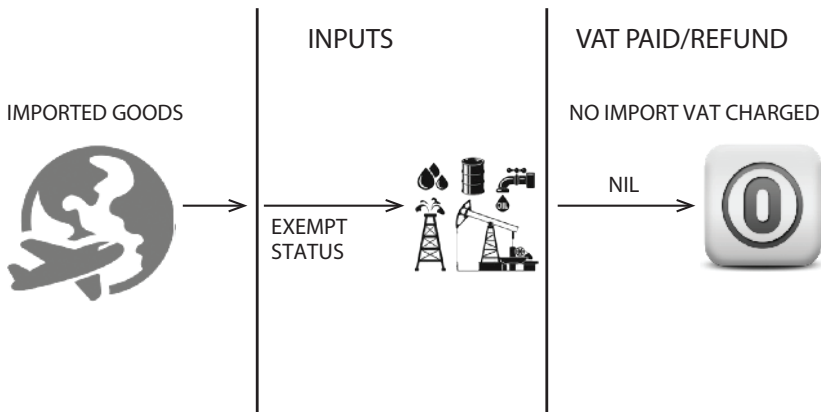


problems faced by government in relation to paying input VAT refunds;

- (iv) Offsetting input VAT refunds against other tax liabilities:
  - i. It is possible to allow extractive industries to offset input VAT refunds owed against other tax liabilities. This approach would, however, require that a unified taxpayer accounting debt management system be in place;
  - ii. It is important to note that allowing offsetting of input VAT refunds against other debts besides tax liabilities owed to government may provide for significant administrative challenges. Further, input VAT refunds should not be offset against future tax liabilities, which cannot be accurately established;
- (v) Ensure that there are extractive industries taxation experts within the general VAT tax administration unit. Not fragmenting the administration of extractive industries allows for harmonized and consolidating procedures in terms of risk management, assessment, payment, appeals and collection, while still recognizing and addressing unique issues of the extractive industries.

Figure IX.7:

**VAT Policy Options: exemption for extractive inputs**



Source: UN/DESA.

## Box IX.1

**Country examples****Ghana**

In 2008, Ghana introduced an administrative measure called the VAT Relief Purchase Order (VRPO) applicable only to the extractive industries. Extractive companies could issue VRPOs instead of paying VAT for certain goods that were specific to the industry. The VRPO system effectively resolved the refund issue for these goods and was similar to providing an exempt status to the extractive industries for these goods.

The VRPO system, however, required additional monitoring to ensure it was not misused. To manage fraud under this system, the Ghanaian tax authority promptly withdrew eligibility to use VRPOs whenever any misuse arose.

The Ghanaian tax authorities stated that they would in due course withdraw the use of VRPOs. This was as a result of systematic and fundamental changes made to the VAT refund system, which allowed quick and efficient processing of refund claims, so that the VRPO system would no longer be required. It has since been replaced by a General Refund scheme where investors and beneficiaries who are granted exemptions on domestic taxes, particularly VAT, will pay VAT to their suppliers and apply for refund.<sup>a</sup>

**Democratic Republic of the Congo**

In 2016, in an attempt to reduce pressure on the domestic currency, the Government of the Democratic Republic of the Congo directed that VAT refunds should no longer be paid until further notice. This saw a significant growth in the amount of refunds due to the extractive industries. In an attempt to decrease the growth in refunds owed, the country temporarily exempted imported goods to the mining industry. The view has been expressed that such an instability in the tax system could have a negative impact on investors' sentiment.<sup>b</sup>

**Zambia**

In 2014, due to strict export documentary requirements, a large amount of refunds due by the Zambian Government accumulated. The Chamber of Mines of Zambia appealed in a media statement to the Government to refund VAT owed to mines. According to this statement, failure to pay VAT refunds would force the already cash-constrained mining industry to cut back on capital projects, lower production, make suppliers wait longer for their money, interrupt certain corporate social investment

projects and diminish the collection of revenue by the Zambia Revenue Authority. This has been commented on as an example of the often unforeseen distortions and negative consequences of not paying VAT refunds in a timely manner.<sup>c</sup>

- a Government of Ghana, *Ghana: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding* (September 2016), paragraph. 41, available at <https://www.imf.org/external/np/loi/2016/gha/091616.pdf>
- b Tom Wilson, “DR Congo’s Government Drops VAT on Imports for Mining Companies”, in *Mining News Magazine*, available at <http://www.miningnews-magazine.org/?p=992>.
- c Lusaka Times, *Chamber of Mines urges Resolution of VAT Rule 18*, (September 2014), available at <https://www.lusakatimes.com/2014/09/24/chamber-mines-urges-resolution-vat-rule-18/>.

### ***Place of supply and consumption as applicable to the extractive industries***

Registered businesses in the extractive industries often make use of service suppliers located in other jurisdictions than the extractive site. Further, an extractive site can be located offshore and outside the scope of a country’s VAT. This section considers these issues and how to potentially treat them for VAT purposes.

#### ***Issues regarding services***

Applying the destination principle to services has been problematic due to difficulties in determining the place of supply and consumption of services. Before the recent growth in globalization and technology, there was little need to establish rules relating to the place of consumption of services, as most services were consumed in the country where they were physically performed. Globalization and technology has resulted in many different proxies used by different jurisdictions in determining the place of supply and consumption of services. These different proxies can create problems such as double taxation, non-taxation and increased administrative and compliance burdens.

In the extractive industries, services are often supplied by suppliers located in other jurisdictions. It is therefore important to determine the place of supply and consumption of these services.

Table IX.3  
Value added tax in the life cycle of the extractive industries

| Life cycle phase                | Key activities undertaken <sup>a</sup>                                                                                                                                    | Input VAT deduction | Output VAT charged                                                            | Key issues                                                                                                                                                                                                                                                                                                  |
|---------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|-------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Exploration                     | <ul style="list-style-type: none"> <li>▪ Locating deposits;</li> <li>▪ Assessing commercial and economic viability; and</li> <li>▪ Typical 3 – 10 year period</li> </ul>  | Yes                 | No                                                                            | <ul style="list-style-type: none"> <li>▪ Surplus input VAT refunds due;</li> <li>▪ Opportunity cost on cash flow; and</li> <li>▪ Exposure to exchange rate depreciation</li> </ul>                                                                                                                          |
| Development                     | <ul style="list-style-type: none"> <li>▪ Preparation of site for production;</li> <li>▪ Establishment of infrastructure;</li> <li>▪ Typical 2 – 4 year period.</li> </ul> | Yes                 | No                                                                            | <ul style="list-style-type: none"> <li>▪ Surplus input VAT refunds due</li> <li>▪ Opportunity cost on cash flow</li> <li>▪ Exposure to exchange rate depreciation</li> </ul>                                                                                                                                |
| Production                      | <ul style="list-style-type: none"> <li>▪ Production and commercial processing</li> <li>▪ Typical 15 – 20+ year period</li> </ul>                                          | Yes                 | Yes — Often at a zero-rate as output is largely exported                      | <ul style="list-style-type: none"> <li>▪ Generally, 0% VAT on export of outputs;</li> <li>▪ Recovery of input VAT;</li> <li>▪ Opportunity cost on cash flow;</li> <li>▪ Exposure to exchange rate depreciation; and</li> <li>▪ Compliance costs for documentary requirements accompanying export</li> </ul> |
| Decommissioning /rehabilitation | <ul style="list-style-type: none"> <li>▪ Removal of infrastructure;</li> <li>▪ Restoration of site</li> </ul>                                                             | Yes                 | Limited amount and often zero-rated as output and infrastructure is exported. | <ul style="list-style-type: none"> <li>▪ Surplus input VAT refunds due</li> <li>▪ Opportunity cost on cash flow</li> <li>▪ Exposure to exchange rate depreciation</li> </ul>                                                                                                                                |

<sup>a</sup> These activities may take longer in practice than the typical period provided in this table.

### *General rules relating to the place of consumption of services*

To avoid double or non-taxation for the supply of interjurisdictional services, taxing rights are granted to a jurisdiction. This generally means that the services will be exported services and zero-rated in other jurisdictions and charged with VAT in the jurisdiction which holds the taxing rights. Of course, it is first necessary to determine whether a supply of services is interjurisdictional before determining taxing rights.

The OECD has set out guidelines that apply the destination principle to internationally traded services.<sup>344</sup> These guidelines as they relate to business-to-business supplies are:

- For consumption tax purposes, internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption;
- The jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles;
- The identity of the customer is normally determined by reference to the business agreement; and
- When the customer has establishments in more than one jurisdiction, the taxing rights accrue to the jurisdiction(s) where the establishment(s) using the service or intangible is (are) located.

It should be noted that the aim of these guidelines is to allocate the taxing rights to ensure that the value added by these services is taxed in the jurisdiction where the goods and services that ultimately arise as a result of the supply of services will be consumed.

### *Place of supply of services*

A further issue is the place of supply of services. Services could either be supplied in another jurisdiction and, therefore, be imported services subject to import VAT, or be supplied in the same jurisdiction as the extractive site and, therefore, potentially be subject to output VAT.

---

<sup>344</sup> See the *OECD International VAT/GST Guidelines* (November 2015). Available at <http://www.oecd.org/tax/consumption/international-vat-gst-guidelines.pdf>.

Whether the services supplied are imported or domestically provided could also be important for the extractive industries, especially if the reverse-charge rule on imported services is applied. If the reverse-charge rule applies to imported services, the extractive industries supplier may well prefer that the services be regarded as imported services. In the case where the services are regarded as domestically supplied, the extractive industries supplier would be entitled to an input VAT deduction on these services, and issues regarding the timely payment of input VAT refunds may arise.

The place of supply is also of importance to the supplier. Generally, if the place of supply of services is in another jurisdiction to that of the supplier, that supplier may be required to register for VAT in the other jurisdiction. This would of course result in a large compliance cost for the supplier.

Based on the above, it may be preferable to allow services provided to the extractive industries from other jurisdictions to be treated as imported services.

#### *Place of consumption and supply of decommissioning/rehabilitation services*

Services supplied during the decommissioning/rehabilitation phase often provide particular place of consumption and supply issues, since these services are supplied in multiple jurisdictions. These services often involve a planning stage and an execution stage. The planning stage will generally take place at the supplier's place of operation or fixed establishment often in a different jurisdiction to the extractive site. The execution stage would take place at the extractive site.

With reference to the section above on general rules, it is evident that the jurisdiction in which the extractive site is located will have the taxing rights for decommissioning/rehabilitation purposes. Although the customer may have establishments in more than one jurisdiction, the taxing right should accrue to the jurisdiction where the decommissioning/rehabilitation will take place (where the applicable extractive site is located). Due to the service possibly being supplied in two jurisdictions, it may be preferred to treat the entire service as an imported service.

*Place of consumption and supply of offshore extractive activities out of the scope of the VAT*<sup>345</sup>

Some extractive industries activities may be performed outside of the territory of a country and may as a result occur outside that country's VAT geographical scope.<sup>346</sup> Goods may be imported or locally purchased to be used at an offshore site outside of the scope of a country's VAT and there may also be services supplied at this offshore site. Some goods may also be moved in and out of the scope of a country's VAT, within a short-time period.

Once goods are removed beyond the scope of a country's VAT, the removal of such goods would constitute an exported supply and be zero-rated. If goods are imported and thereafter exported to an offshore site situated outside of the scope of a country's VAT, the issue of VAT refunds may again arise and a country may consider the policy and administrative approaches discussed in the section on VAT policy and administration (above). This would also be the case where goods move in and out of the VAT scope within a short-time period.

For services physically performed at the offshore site, which is outside of the scope of a country's VAT, the place of supply of the services will not be in any country. The place of consumption of the services would depend on whether the supply of services is directly connected with immovable property situated at the offshore site. If this is the case, the place of consumption would be at the offshore site and no country would have taxing rights on the service supplied.

Where the supply of services is not directly connected with immovable property situated at the offshore site, the place of consumption of the services may be argued to be within the country that the customer is located (the extractive industries' onshore establishment). The services will therefore be imported services and the reverse-charge rule should be applied to these services.<sup>347</sup>

---

<sup>345</sup> If the extractive site is situated within the scope of the VAT, then no special consideration is required.

<sup>346</sup> This is generally 12 nautical miles from the shore of a country.

<sup>347</sup> Refer to the *OECD International VAT/GST Guidelines* for further discussion regarding the place of consumption of interjurisdictional services.

## *Conclusion*

From a developing-country perspective, while the benefits of having a VAT mechanism in place are clear, the effects of the system not working effectively should not be understated. Investment decisions and cash flow could be affected, and spillover effects on local content could also be a consequence. While the extractive industries should generally not be seen as different to other industries, given its predominant export character, an efficient VAT mechanism along with supporting administration is especially important to it. An inefficient system can increase project costs and discourage investment. In particular, VAT for the extractive industries should not be seen as merely a revenue generation tool.

Finding the right balance between providing VAT policy and related administration that is attractive to extractive investors and also supports growth of the domestic economy would ease perceived barriers to investment. As noted, VAT revenue from the extractives industries is likely to be minimal in countries where the industry is largely export-oriented, but administration of the VAT could provide challenges for continued investment in the industry.

From a policy perspective, the ideal approach would be to apply full taxation to this industry. If the full taxation approach is not administratively feasible, deferring the import VAT on capital goods by requiring suppliers to report the VAT in their following VAT return may be preferable. Generally, to protect the domestic market, exemption or zero-rating of goods and services supplied to the extractive industries is less preferred.

From an administrative perspective, measures should be put in place to decrease the delay in paying input VAT refunds. These could include an improved risk-based auditing approach and post-refund audits of low risk input VAT refunds. Further, forecasting tools can assist in ensuring sufficient revenue is allocated and available for input VAT refunds. If a taxpayer accounting and debt management system is in place, it may also be beneficial to allow taxpayers to offset input VAT refunds against other tax liabilities.

Structured dialogue between government and the extractive industries could also provide for solutions to the issues discussed in this chapter that are tailored to each country's specific context.



## Glossary

**Abandon in Place:** A disposal option category in which all or part of an installation is left in its position for controlled, natural deterioration and where the marking of the installation can be maintained.

**Arm's Length Principle/Standard:** The arm's length principle is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances.

**Artificial reef:** A structure placed on the seabed to provide anchorage and shelter for marine life.

**Associated enterprises:** Enterprises under common control. This will generally be the case where the same persons participate directly or indirectly in the management, control or capital of both enterprises.

**Best practical option:** The disposal option which both for the licencees and the authorities is considered as the most cost-effective solution without compromising internal and external regulations on health, environmental, safety and emergency preparedness issues.

**Bonuses:** Lump sum (or sometimes staged) payments made to a government upon award of a natural resource licence or some other project event.

**Cessation plan:** A "close-down" plan containing the licencees' proposal for disposing of the installations and associated interconnecting pipelines.

**Capital Gain Tax (CGT):** Generally used (especially in chapter 4 of this publication) to include taxation of a capital gain either through a separate specific capital gains tax regime or through the general income tax system.

**Cold installation:** Installation without presence of hydrocarbon/inflammable liquids (class A or B) or inflammable gas.

**Cold phase:** Any period of time during which an installation is "cold", cf. definition of "Cold installation" above.

**Concession regimes:** Structures involving government grants to an entity of the rights to exploration, development, and extraction of natural resources at the grantee's sole risk. Grants generally cover a fixed area and impose certain time limits for the activities. These regimes are sometimes also known as "tax and royalty" regimes and are common in both the petroleum and mining industries.

**Concrete installation:** A reinforced concrete structure founded on the seabed, and supporting topside structures over the wave zone.

**Consortium or joint venture:** An arrangement of several investors who may pool capital and expertise to jointly exploit and share the risks connected with exploiting a particular extractive project.

**Continued use:** A disposal option category in which it has been decided to continue use of all or part of an installation in the petroleum industry or a mine.

**Contract regimes:** Structures involving government appointment of an entity as a contractor who agrees to bear exploration, development and other costs at its sole risk in return for a share of production in the case of a success; more common in the petroleum industry and can be structured as a production sharing contract/ agreement (PSC or PSA) or a risk service contract.

**Contractual area:** Oil and gas activities are related to the geographical areas delineated in the petroleum contract. They could also be identified, in general and depending on the country, as the "field" or "block".

**Comparable data:** In the transfer pricing context, these may be internal comparables, i.e. transactions between the tested party and independent parties, or external comparables, i.e. transactions between two independent entities that are not a party to the controlled transaction.

**Comparable Uncontrolled Price (CUP) Method:** A transfer pricing method comparing the price of the property or services transferred in the controlled transaction with the price charged in comparable transactions in similar property or services in similar circumstances

**Controlled foreign corporation (CFC):** A corporation normally located in a low-tax jurisdiction and controlled by shareholders

resident in another country. A CFC legislation normally combats the sheltering of income in such corporations in low tax jurisdictions by attributing a proportion of the income sheltered in the corporation to the shareholders in the country where they are resident.

**Controlled transaction:** Transaction between associated enterprises for the transfer of property or services. The term may also be used to denote a transaction between related enterprises which is the subject of a transfer pricing analysis.

**Cost contribution arrangement (CCA):** It is an arrangement between enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The arrangement sets out the responsibilities and risks of the participants and the nature and extent of the interest of each participant in the assets, services or rights resulting from the arrangement.

**Cost oil:** Portion of produced oil that the operator applies on an annual basis to recover defined costs specified by a product sharing contract.

**Cost Plus Method:** A transfer pricing method that evaluates the arm's length nature of an intercompany charge for tangible property or services by reference to the gross profit markup on costs incurred by the supplier of the property or services. It compares the gross profit markup earned by the tested party with the gross profit mark-ups earned by comparable companies.

**Cost sharing arrangement (CSA):** The term used in the United States to describe a cost contribution arrangement between enterprises to share the costs and risks of developing intangible assets. The arrangement would normally set out the contributions of the participants and define their share in the results of the assets resulting from the arrangement.

**Country-by-Country Report:** The final Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting report on Action 13 (2015) on transfer pricing documentation included a Country-by-Country (CbC) reporting requirement for multinational groups that meet a specified turnover threshold to provide aggregate information on an annual basis covering the jurisdictions in which they operate giving details of entities, income and taxes paid in each jurisdiction and indicators of economic activity and substance.

**Cost stop:** A limitation set to the amount, types or proportion of cost oil that can be considered as cost oil. When defined in a product sharing contract, the cost stop is generally set per reporting period.

**Creaming mechanism:** A mechanism or provision that allows for the proportion of government revenue to increase if certain aspects of the extraction or relevant financials improve. Such mechanisms can depend on things such as the commodity price, volumes produced or even overall profitability of the project. In general, these mechanisms will also ratchet down and decrease government revenue in case the price, volume produced or overall profitability decreases.

**Decommissioning:** Prepare a hot installation for a disposal option or a cold phase to be followed by disposal (deferred disposal).

**Deferred disposal:** Disposal after a cold phase, or after continued/other use under the current licence, whereby the economical or technological advantages of delayed disposal may be realized.

**Disposal:** An agreement or a process of deconstruction/dismantling/modification and/or transportation, which brings an installation to its final destination.

**Double Tax Agreement (DTA):** An agreement negotiated by two (or more) countries to ensure the avoidance of double taxation.

**Double tax treaty (DTT):** See DTA.

**Downstream:** The term refers to activities related to the transportation of crude oil and natural gas and to the refining, storage, distribution and marketing of crude oil and its derived products.

**Environmental impact assessment (EIA):** A process of evaluating the likely environmental impacts of a proposed project or development, taking into account inter-related socio-economic, cultural and human-health impacts, both beneficial and adverse.

**Exemption:** An exemption means that no VAT is charged on a supply of goods and services and no input VAT deduction can be claimed.

**Extractive industries:** Those industries engaged in finding, developing, producing, and selling non-renewable resources such as crude oil, natural gas, and hard minerals and their products.

**Farm-out/Farm-in agreements:** Common oil and industry farm-out agreements, where the owner of an oil or gas interest (the Farmor) agrees to assign part of its interest to another party (the Farmee), in exchange for certain obligations relating to development of the oil or gas interest.

**Farmor:** the owner of an oil or gas interest and a party in a farm-out agreement who assigns part of its interest to another party (Farmee).

**Farmee:** A party in a farm-out agreement who receives part of an oil and gas interest as an assignment from the Farmor.

**Fiscal systems:** The general economic framework governing natural resource activities, generally falling into two broader categories: concession regimes or contract regimes.

**Fiscal terms:** Specific economic elements relating to extractive industries activities within a particular country including taxation, other payments such as bonuses and royalties, legal framework, and state participation.

**Full taxation:** In relation to VAT, full taxation means that a single rate is applied to all goods and services in the economy, i.e., there are no exemptions, no zero ratings (except for exported supplies) no reduced ratings or other alternative policies applicable to the VAT.

**General Anti-Avoidance Rule or General Anti-Abuse Rule (GAAR):** A rule in tax statutes or sometimes as evolved through judicial decisions (such as “substance-over-form” approaches) empowering a revenue authority to deny taxpayers the benefit of an arrangement that they have entered into for an impermissible tax-related purpose (usually only where this is a main purpose or the sole purpose, differentiated for example from non-tax business or commercial purposes). It is general in nature and descriptive, because it is meant to be able to address abuses not specifically identified in law.

**Grandfathering:** A grandfather clause is an exemption that allows persons or entities to continue with activities or operations that were approved before the implementation of new rules, regulations or laws.

**Import VAT:** VAT paid by a recipient of imported goods or services. Import VAT is generally paid to a customs or similar office on the importation of goods and to a branch of the tax administration or post office on the importation of services.

**Input VAT apportionment:** An input VAT apportionment will generally need to be made where a registered supplier acquires goods or services partly for making taxable supplies and partly not for making taxable supplies.

**Input VAT:** VAT charged on a supply of goods or services to a purchaser, where the VAT may be deducted or reclaimed by the purchaser. The VAT will in most cases be deductible if the purchaser is registered for VAT and acquires the goods or services for the purpose of making taxable supplies. Note that the terms “input credit” or “VAT credit” are often used to mean the same as “input VAT deduction”.

**Installation:** Fixed platform and associated systems, inventory, bridges, tripods and risers.

**Internal rate of return (IRR):** Metric used to measure the profitability of (potential) investments. The higher an investment’s internal rate of return, the more profitable it is expected to be and the more desirable it will be to undertake. The internal rate of return is the discount rate that makes the net present value of all cash flows from a particular project equal to zero.

**International oil company (IOC):** Largely publicly traded, an internationally operating company involved in the oil and gas industry.

**Jacket installation:** A tubular steel structure founded on the seabed, and supporting a topside structure over the wave zone.

**Joint Operating Agreement (JOA):** An association or consortium of two or more oil and gas companies engaged in a business enterprise regarding a contractual area without actual partnership or incorporation. The JOA regulates the management of the operation and decision-making.

**Licence holder:** Person obtaining the licence to explore and extract the natural resource from the State, often through a process of competitive bidding.

**Module support structure (MSS):** A generic term used to describe the structures whose purpose is to transfer loads from the modules to the jacket.

**National oil company (NOC):** A largely government-owned company, predominantly involved in oil and gas industry in that country.

**Non-operator:** In the joint operating agreement, the participating oil and gas companies, other than the operator.

**Operator:** The entity in charge of performing the actual extractive industries activities with respect to a particular project. It can be the licence holder, or one of the licence holders if the licence was granted to a consortium or joint venture. In a joint operating agreement, the operator is in charge of the current and ordinary activities and of implementing the decisions made by the parties through the management committee. Normally, the operator can act with some freedom in all areas not specifically falling under the decision-making powers of the committee formed by the partners.

**Output VAT:** VAT charged on the supply of goods or service by a registered supplier.

**Parent company guarantee:** A parent company guarantee is a guarantee by a parent company of a contractor's performance under its contract with its client, where the contractor is a subsidiary of the parent company.

**Permanent establishment (PE):** Term used in double taxation agreements to refer to a situation where a non-resident entrepreneur is taxable in a country—that is, an enterprise in one country will not be liable to the income tax of the other country unless it has a “permanent establishment” through which it conducts business in that other country. Even if it has a PE, the income subject to taxation will generally only be taxed to the extent that it is “attributable” to the PE.

**Petroleum contract:** Legal document signed between the government and the contractor giving title (mining domain) and exploration and production rights to the contractual assigned area. There are several configurations, even in the same country, in terms of the rights and obligations assigned to the parties. These contracts can be classified as follows: (i) concession or licence contracts; (ii) production sharing agreements or contracts (PSCs); or (iii) service contracts.

**Piece small:** Reducing, in the case of steel structures, the installation material into pieces no larger than 1.5m x 0.6m, thus making them suitable for inserting in a steel mill furnace. For concrete structures, reducing the concrete to rubble, or to lift able sections.

**Plug and abandonment (P&A) operations:** Localization and securing of well zones where flow of oil or gas may occur between zones or to the surface.

**Precautionary principle:** If an action or policy has a suspected risk of causing harm to the public, or to the environment, in the absence of scientific consensus (that the action or policy is not harmful) the burden of proof that it is not harmful falls on those taking that action.

**Production sharing contract (PSC) (or Production Sharing Agreement, PSA):** A term used in the hydrocarbon industry which refers to an agreement between a contractor and a government, with regard to the exploration and production of hydrocarbons, whereby the contractor bears all exploration risks, production and development costs in return for its stipulated share of (profit from) production resulting from this effort. The costs incurred by the contractor are recoverable in the event of a commercial discovery. Thus, a PSC is a fiscal regime for the exploration and production of hydrocarbons.

**Profit oil:** The amount of production, after deducting cost oil, allocated to costs and expenses that will be divided between the participating parties and the host government under the product sharing contract.

**Provision:** An amount set aside from a company's profits for an expected liability or for the decreasing value of an asset, though the specific amount might be unknown

**Registered supplier:** A person that is registered or required to be registered for value added tax.

**Related parties:** Entities under common management, control or ownership, or where one entity controls the other entity.

**Removal:** A disposal option in which all or part of an installation is moved completely or partially from its present position, and deposited, or further dismantled, in order to recycle, reuse, or deposit its constituent materials and components.

**Resale Price Method:** A transfer pricing method that analyses the price of a product that a related sales company charges to an unrelated customer, i.e. the resale price, to determine an arm's length gross margin that the sales company retains to cover its sales, general and



administrative expenses and still make an appropriate profit. The remainder of the product's price is regarded as the arm's length price for the transactions between the sales company and a related party.

**Reserves replacement ratio (RRR):** A performance metric which indicates to what extent entities are able to find and prove new hydrocarbon reserves in comparison to the hydrocarbon reserves produced. The RRR indicates to what extent future resource production equals current resource output from existing sites.

**Reuse:** Further use of an installation, its parts, systems or inventory in a new or existing location.

**Reverse-charge rule:** A rule that is often applied to imported services. The recipient of the imported services would be required to self-assess the VAT on such services.

**R-factor:** A profitability ratio defined by a contractor's cumulative revenues to the contractor's cumulative costs.

**Ring-fence:** Tax treatment attributed to some contracts whereby each contract is treated as an independent and autonomous unit. As a result, in general, losses from one contractual area cannot be offset against profits from another contractual area, even if both contractual areas are using the same contractor.

**Risk assessment:** Analysis including a systematic identification and categorisation of risk to people, the environment, assets and financial interests.

**Royalty:** In the extractive industries, the term "royalty" refers to the obligatory payment made by the operator of the extraction project to the country as a compensation for the extraction rights. Royalties are generally calculated with reference to the type, quantity, quality, and/or value of the extracted mineral resource as a percentage of the gross volume or value of the production (i.e., costs generally do not reduce the base) and are due once production commences. The term "royalties" as defined under Article 12 of the United Nations Model Convention has a different meaning and refers to the payment for the right to use property (in the case of the United Nations Model, both tangible and intangible).

**Specific Anti-Avoidance Rule (SAAR):** A rule in tax statutes empowering a revenue authority to deny taxpayers the benefit of a

particular known and defined arrangement. It has a very limited scope of application and allows only limited discretion to the tax authorities compared to a GAAR. Like most GAARs, however, some specific rules have a purpose test, rather than relying purely on objective factors such as publicly quoted market prices.

**Service provider or subcontractor:** A company or individual providing various types of services and other supplies in the framework of the extractive industries.

**State participation:** Direct government ownership or shareholding in a portion of a project and or extractives company (beyond its ownership of the underlying resource reserves); also known as “equity participation”.

**Structure:** A part or whole of an installation.

**Supply:** The term “supply” has a wider meaning than the term “sale” in normal usage and also includes, for example, rental agreements, instalment credit agreements, involuntary disposals and compulsory disposals.

**Tax oil:** Tax oil is the part of the profit oil that is used to actually pay income taxes owed by the investors on their profit oil. This is not always defined in the production sharing contract.

**Taxable supplies:** Supplies of goods or services by a registered supplier that are charged with VAT. This will include supplies that are charged with the standard VAT rate, a reduced VAT rate in the case of a country that applies multiple VAT rates, or a zero-rated supply.

**Toppling:** Controlled rotation of an installation (with or without topsides) from a vertical to a horizontal position resting on the seabed.

**Transactional Net Margin Method (TNMM):** A transfer pricing method (TNMM) that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. This is compared to the net profit margins earned in comparable uncontrolled transactions.

**Transfer pricing:** The general term for the pricing of cross-border, intragroup transactions in goods, intangibles or services.

**Transfer pricing adjustment:** An adjustment made by the tax authorities to the profits of an enterprise after determining that the transfer price of a transaction with a related party does not conform to the arm's length principle.

**Treaty Shopping:** The practice of structuring an investment/business activity so as to take advantage of a particular tax treaty. The term is normally applied to a situation where a person not resident of either of the treaty countries establishes an entity in one of the treaty countries in order to obtain treaty benefits.

**Uncontrolled transaction:** A transaction between independent and unrelated enterprises.

**Unconventional oil and gas:** Unconventional oil is petroleum produced or extracted using techniques other than the conventional (oil well) method. Oil industries and governments across the globe are investing in unconventional oil sources due to the increasing scarcity of conventional oil reserves.

**Upstream:** The term refers to activities related to the exploration and production of crude oil and natural gas, the beginning stages of the life cycle of an extractive industry project, and which involve large upfront capital investment that carries significant risks in terms of achieving commercially successful results.

**Value added tax (VAT):** A general, broadly based consumption tax assessed on the value added to goods and services.

**Zero-rate:** A zero-rate for the purpose of VAT means that a supply will be charged with VAT at zero per cent and a registered supplier would remain entitled to an input VAT deduction.

