THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 3.04 – UPSTREAM OIL AND GAS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

There are three main international oil and gas agreements: Concession, Production Sharing Agreements and service contracts.

A concession is a grant by a country to a foreign company to develop its oil and gas reserves on an exclusive basis in a defined area during the duration of the agreement. According to concession regimes, title to oil and gas is transferred to the international oil and gas company. Title is given to the extracted oil and gas but not to the total oil and gas exist in situ. Companies acquire rights to control large areas of land/sea to carry out their operations over a relatively long period of time (up to 75 years in some cases). The contractor pays all the costs associated with exploration, development and production activities without any guarantee from the host government to recover any of these costs.

According to PSA the government retains titles to oil and gas reserves but gives the contractor a share to production, known as profit oil. The international oil and gas company bears all the pre-production risks and costs and when commercial reserves are discovered the contractor is entitled to recover its costs via cost oil. The remaining oil and gas (the profit oil) is split between the international oil and gas company and the host government according to a pre-agreed formula, this can be fixed percentage or on a sliding scale basis. The company still has to pay taxes on its share of the profit oil; in some cases company's taxes is paid by host government from their profit oil share.

In service contracts the international oil and gas company is paid fee by the host government for providing services in form of exploration, development and production activities – these are called non-risk service contracts. In risk-service contracts the oil and gas company receives its fees only upon discoveries of commercial oil and gas reserves. Oil rich countries use these types of contracts due to their lack of technical experience in the oil investment businesses. Under these contracts the contractor may receive his fee in cash or kind (oil and gas), while under PSA no cash is paid by host government to the contractor for his share – profit oil and gas (in kind payments) is shared between the parties.

Part 2

Royalties

Royalties are usually based on production or value of oil and gas produced. Royalties may be based on different values including:

- Fixed percentage – for example United State Federal royalties.
- A bid amount, applied on several states in the United States, for example Louisiana state royalties.
- Vary with geological features, for example Nigeria offshore royalties decrease with the geological features of greater water depth.
- Sliding scale royalties based on production, for example China and Abu Dhabi.
- Sliding scale royalties based on other several factors, for example Alberta in Canada, based on production and price.
- Sliding scale royalties depending on IRR, for example Greenland.

In the United States, royalties are paid either to the mineral owner, and may be 'Federal' royalties applying to offshore oil fields beyond state territorial sea jurisdiction or 'state royalties' applying to onshore and state territorial sea fields, or are paid to the private resource owner. The royalty may be based on fair market prices, or deemed prices.

Royalties may be based on the well-head price, field terminal price, or the export terminal price. They may also be referred to as severance tax. Several states in the United States impose severance taxes at 2% to 10% of the volume produced, or severance taxes may be based on a percentage of gross receipts.

Excise taxes, are also taxes based on value of production. The term may be used to distinguish the excise from royalties where there are different methods of calculation and revenue sharing arrangements. For example, in the Australia North West Shelf, Federal crude oil excise is imposed on production from the project area. Federal royalties are also imposed, however the royalties are shared with the Western Australia state government.

Royalties are usually combined with other tax systems, such as Concession and PSC regimes. This generally because they give rise to income to the state as soon as production commences, whereas government revenue from Concession and PSC regimes is delayed as the oil and gas company uses carry-forward tax losses or allowable costs from prior years.

Signature and Production Bonuses

Many countries require signature and production bonuses as payments to be made at stages of exploration and production. Bonuses may arise as part of the bidding process for a new exploration and development licence or be imposed under standard terms such as PSC.

Bonuses may include:

- Signature bonuses: payable on signing the oil and gas agreement, for example on signing of the PSC or block exploration and development licence.

- Capacity building bonuses: an amount paid to assist in the development of facilities such as project infrastructure, and generally payable at an early stage in the contract.

- Bonuses may be payable on discovery, commercial discovery, licence application, specific levels of production, or levels of cumulative production.

Signature bonuses may provide compensation for government costs in conducting the bidding process, and will provide income for government oil and gas administration where there are dry wells. The much larger sources of income are production bonuses where significantly higher amounts are paid on meeting oil and gas production milestones. For example, Tengiz contract in Kazakhstan with Cheveron requiring a signature bonuses of USD 25m, together with a bonus of USD 210m after 90 days of operation, and a bonus of USD 210m after 12 months.

Bonuses are generally not cost recoverable under PSC regimes, meaning that the oil and gas company does not get cost oil to repay these expenses. Bonuses may qualify for tax relief under tax regimes, for example lease bonuses are amortised for United States federal tax.

Bonuses are significant as an example of amounts which generally apply at levels of production, and therefore are larger if an oil and gas development becomes successful. They are distinguished from royalties, however, as they are not payments for oil and gas resources, and so may be considered to be sharing the benefits of a project when it reaches specific development milestones.

Question 2

Part 1

Ring fencing provisions impose limitations on deductions for tax purposes across different activities or projects undertaken by the same oil and gas company. It is therefore common for countries to "ring-fence" upstream natural resource operations, so that only costs directly attributable to them are taken into account in taxing them. Ring-fencing is a special technical issue for natural resource tax administration. This may require contractors or concessionaries to restrict cost recovery and or deductions associated with a given area, block or license (or sometimes even a specific field) to that project. This means that all costs associated with a particular block or licence must be recovered from revenues generated within that same block.

Where ring-fencing applies by reference to contract or license area, companies operating in different contract areas will need to allocate costs between them, but some countries require a separate company to be established for each contract area, which reduces the need to apply ring-fencing rules. This approach may be less cumbersome from an administrative viewpoint but may be inefficient to the oil and gas company investing.

Ring fencing can be applied on different scopes. Some countries ring-fence their oil and gas activities from other commercial activities performed by the same entity (as downstream operations) in the country, whilst others ring fence individual projects from other projects held by the same oil and gas company. The ring fencing provision may apply to individual licenses or on a field-by-field basis. In a ring fencing situation, exploration expenses in one non-producing block may not be deducted against income another block for the purpose of tax calculation and assessment. Under Production Sharing Contracts, as a general rule, ring fencing provisions act in the same way, where cost incurred in one ring fenced block cannot be recovered from another block outside the ring fenced area.

Implementing ring fencing provisions in the tax regimes applicable to oil and gas companies could lead to a higher tax on the overall oil and gas revenues. If a company operates in several ring-fenced areas it is required to calculate profits separately for each of the ring fenced areas and may not consolidate the costs for tax purposes. However, if all the projects held by the company are successful and economically profitable it should only constitute a timing difference issue as the costs will still be recovered but this would happen latter on the project in case ring fencing applies. Allowing companies to offset those costs might give an advantage to existing industry players over new entrants with only one license.

For oil and gas producing countries, these rules have an impact because the absence of ring fencing limitations can postpone government tax receipts as the company that undertakes a series of projects is able to deduct exploration and development costs from each new project against the income of projects that are already generating revenue and taxable income. This way, by introducing ring fencing provisions government revenues arising from tax receipts can be accelerated. If no ring fencing applies this would potentially reduce the (higher) taxes intended to be collected from those projects. Additionally, if there are no ring fencing provisions in place and different tax regimes apply to different areas, companies could allocate costs disproportionately to higher taxed areas to reduce their tax assessments. One other aspect is that where countries impose progressive taxes, area ring-fencing provisions can mean companies pay high taxes on "excess profits" from one area, even though they have not made excess profits (or have even suffered a loss) in the jurisdiction considered as a whole.

Ring-fencing provisions can add significant administrative complexity and risk, particularly when license areas or even individual projects are ring-fenced, as it is the case in many countries. Also, ring-fencing may hamper companies undertaking further exploration and development activities due to the inability to claim deductions for such activities on existing projects. It may also encourage tax planning if the ring-fence tax regime is more onerous than the standard tax regime. For example, locating lower-taxed downstream activities outside the ring fence, including in another jurisdiction, or transfer pricing to shift profits outside the ring fence or costs inside the ring fence. Another concern with ring-fencing provisions is that it can be especially complex where one tax (such as a resource rent tax) is ring-fenced but another tax (such as the CIT) is not.

Part 2

As mentioned above some countries ring-fence their oil and gas activities (usually under corporate income tax) whilst others ring-fence individual projects (usually under special petroleum taxes). If we look at some example of countries that apply these types of provisions, we can find Denmark which applies ring fencing provisions so that losses from non-oil as gas activities cannot offset profits from hydrocarbon production. In Greenland, there is no field ring fencing but oil and gas explorations income or costs may not be offset against income and cost from other activities. Kazakhstan applies ring fencing between Production Sharing Contracts individually and between oil and gas production and exploration and other activities. Norway has a different way of applying ring fencing limitation. In Norway, only 50% of onshore losses may be used to offset offshore profits in a clear incentive to prefer offshore exploration. In Qatar which uses Production Sharing Contracts, ring fencing provisions do not allow the communication of costs to offset profits pertaining to a different contract. The ring fencing provisions in the UK provide that onshore losses may not offset offshore profits but there is a first-year capital allowance of 100% for capital expenditure from the ring fenced trade. Cases of oil and gas producing jurisdictions without ring fencing provisions include Brazil, Saudi Arabia and the United States.

PART B

Question 4

Part 1

The analysis includes the structure to obtain interest deductions, generally known as “debt push down”, and the issue of the limitation on interest deduction under most PSC regimes.

There are opportunities relating to depreciation deductions in an acquisition, particularly to allocate a greater part of the purchase price of the acquisition to the value of depreciable assets, generally known as “asset step up” to increase future depreciation deductions.

Tax issues may be a significant issue, particularly where there are accrued exploration and development expenses of oil and gas fields.

The seller may prefer to sell shares, however, as this may be exempted from tax, for example, under the ‘participation exemption, provisions operating in many European countries. A share transaction requires greater due diligence as the purchaser will acquire the company together with all its liabilities.

It is increasingly common for offshore transfers of shares to be taxable by in the host country, either by assuming a deemed disposal of local assets and liabilities with a depreciation step-up, or by seeking to tax the offshore gain directly with consequent difficulty in collecting the tax.

Farm-out/farm-in arrangements may be used, where the investor agree to share future expenses in return for a share of the oil and gas development. these arrangements may not be taxable if the consideration is uncertain, for example the costs of developing an oil or gas well are not known, whereas cash payments for the farm-in are generally taxable.

Taxation issue relating to sale and purchase agreements include whether the seller provides effective warranties and indemnities relating to tax. These clauses may determine whether the buyer or seller will pay the potential tax on the acquisition, whether the seller is responsible for the value of any stated tax losses, and which party is responsible for tax in the period after executing the contract and the final closing date.

There is an issue with indemnities which may be provided by the seller, particularly whether tax indemnities have a financial or time limit, and the indemnities should be provided by the seller’s ultimate parent company, rather than a holding company which may have limited assets.

The tax due diligence process is analysed, including access to physical or online data rooms provided by the seller, information that should be requested by the purchaser, the tax team’s input to financial modelling for the investment, materiality levels for reporting tax balances.

Part 2

The comparable uncontrolled price (CUP) method is a comparison of prices charged in a controlled transaction to the price charged in an uncontrolled transaction in comparable circumstances for comparable produces and services.

The resale price method (RPM) is based on the resale price at which a product purchased from a related party is sold to an independent enterprise. The transfer price of the inter-company transaction is calculated by deducting the resale price margin from the resale price in the uncontrolled transaction.

The cost plus method (CPM) is based on the cost incurred by the supplier of property/services in a controlled transaction. A mark-up taking into consideration the functions performed, risks assumed and assets employed is added to the costs to determine the arm’s length price in the controlled transaction.

The Transactional net margin method (TNMM) is based on the net profit margin relative to an appropriate base, for example cost, sales, or assets, realised from a controlled transaction.

The profit split method (PSM) is based on identification and appropriate split of the profit realised by related entities from a controlled transaction.

Question 4

For a definition of permanent establishment, we should look to article 5 of the OECD Model Convention and the definition in the domestic law of the jurisdiction where we are analysing the impact in.

The OECD defines permanent establishment as a “fixed place of business through which the business of an enterprise is carried on”. This can include a place of management, branch, office, factory, workshop, a mine, an oil and gas well, a quarry or any other place of extraction of natural resources. This concept could also include a building site or construction or installation project that last for more than 12 months.

A dependant agent can also be, in some situations, be considered as a permanent establishment of an enterprise when the agent exercises authority to conclude contracts on behalf of the enterprise. This would however exclude an independent agent working on a general commission or a broker.

As a general rule, the concept of permanent establishment excludes places of business solely for activities or a preparatory or auxiliary nature (e.g. representative office). For the exclusion to apply the representative office may not have authority to negotiate or conclude contracts on behalf of the enterprise (e.g. subjecting approval to home office approval) and should not be a taxpayer in the host jurisdiction.

For oil and gas service companies it is common to establish a representation office in a specific oil and gas jurisdiction to advertise their services to the incoming oil and gas explorers and producers to try and gather contract leads which will then be negotiated and agreed by the home office contracts team. This should avoid the oil and gas service company having a permanent establishment in the host jurisdiction. An alternative to this, depending on the preferred structure, the oil and gas service company can incorporate a separate legal company which would register as a taxpayer and hire their own human resources for the project. This would avoid subjecting to tax the profits of the home office oil and service company but would subject to tax the profits arising from work performed in the host jurisdiction.

Tax treaties should also be considered as potential ways to avoid the existence of a permanent establishment, particularly where the domestic provision on permanent establishment are more stringent than the tax treaty definition.

For oil and gas service companies one of the biggest concerns with respect to their operations is how permanent establishment rules interact with local content rules. The local content rules in the jurisdiction could require the oil and gas service company to register or establish a specific presence in country which could lead to a permanent establishment taxation of profits in said country.

Certain structures can be used to prevent the risk of having a permanent establishment. An example of this is the set-up of local joint venture, fully registered and taxable in country, together with a local company or another oil and gas service company. This would avoid a potential issue of the oil and gas service company being considered to have a permanent establishment in the host country and exposing their profits to local taxation. The oil and gas service company can also agree to establish a consortium including local or foreign company.

In setting up these structures, oil and gas companies should analyse potential tax impacts arising from withholding tax on payments to non-residents for income with a source in the country and possible ways to mitigate this impact by using a credit mechanism or having an agreement with the oil and gas company to gross up the payments to include the withholding tax due.

The oil and gas company should also pay attention to the potential existence of rules that allow a foreign company to be taxed in their jurisdiction for work done overseas and the risk those rules could apply if there is not a double tax treaty in place to override said rules but also the application of the attraction principle, as present in the United Nation Model Convention that allows certain source income to be taxed in country even if a permanent establishment is considered not to exist.

PART C

Question 5

The primary commercial reason to use a group treasury company, in-house banking facility, or similar entities, is to centralise the treasury and finance functions within a multinational group.

This approach enables borrowing under larger-scale programmes on financial markets to achieve lower interest rates than may apply to much smaller loans taken by individual group subsidiaries under separate local bank borrowing.

There may also be advantages in longer-term borrowing resulting in lower interest rates compared to shorter terms for the subsidiary company loans.

The result is generally a significant reduction in group funding costs.

The group treasury company typically undertakes activities such as foreign exchange management, where different foreign currencies are exchanged, for example, based on the currencies of oil and gas income, the needs of the subsidiaries to meet exploration and development expenses, and the funding currencies of the multinational group's borrowing.

The group treasury company may potentially conduct centralised foreign exchange hedging of the group's net foreign currency exposure.

There may also be opportunities for the group treasury company to conduct related activities, for example group leasing and insurance activities.

There is a significant potential benefit from the 'netting off' function. For example, where a subsidiary owes certain amounts to the group treasury company on funding for its local activities, and is also owed amounts by the group treasury centre relating to sales of oil and gas, the two balances may be netted off, with interest only payable on the net balance.

The netting off structure can substantially reduce withholding taxes payable in the subsidiary countries.

The use of a group treasury company results in a margin of profit in the group treasury company based on the difference between interest charged to subsidiaries on smaller loans, and the smaller interest expenses on the group treasury company's large-scale market borrowing.

There may potentially be a significant reduction in the multinational's group effective tax rate where this profit margin is derived in a lower taxing country, such as the Netherlands, Switzerland, Luxembourg or Singapore.

In order to reduce withholding tax on payments from the borrowing subsidiaries, and to reduce withholding tax on the group treasury company's own borrowing from the financial markets, the group treasury company needs to be located in a country with a good tax treaty network.

Question 6

Part 1

Decommissioning requirements are becoming more expensive, with new environmental laws being introduced, and there is increasing responsibilities for decommissioning under international conventions. Therefore, the expected costs are increasing.

The costs of decommissioning are generally deductible for tax purposes when they are incurred at the end of the oil and gas field life.

As decommissioning costs incur at a later date, therefore an annual provision is generally required for accounting purposes. However, this provision is not deductible for tax purposes.

Decommissioning must be provisioned in the accounts in respect of expenses which may arise 10 or 20 years in the future, but no tax reduction is allowed until the actual decommissioning takes place.

In some countries, oil and gas companies make prepayments of future decommissioning expenses to a decommissioning fund, so that deductions can be made over a life of the oil and gas fields to match the provisioning required for the accounts.

The decommissioning fund could potentially lend funds back to the oil and gas company until required to meet the decommissioning costs.

Many countries have tax rules restricting deductions for prepayments, however, and while the time limit varies, deductions for prepayments generally cannot extend much beyond a one-year period.

Part 2

In the United Kingdom, HMRC have stated that a provision is generally deductible where:

- It is in respect of allowable revenue expenditure and not for example, in respect of capital expenditure.

- It is in accordance with United Kingdom generally accepted accounting principles (UK GAAP) including IFRS12 and IAS 37.

- It does not conflict with any statutory rule governing the time at which expenditure is allowed and it is estimated with sufficient accuracy.

- Deduction of decommissioning costs arises only when operations are ceasing, and there may be no further taxable profits arising to utilise the decommissioning deductions.

- The United Kingdom corporation tax rules allow loss carry-back of general decommissioning losses and mineral losses against ring fence profits back to April 2002.

- The UK government has agreed a legally binding framework with the oil and gas industry to ensure long term certainty on the tax relief regime for decommissioning costs, which helps to safeguard continuous investment in the North Sea. The agreement, known as Decommissioning Relief Deeds (DRDs), ensures operators can plan for and quantify the future decommissioning costs.

Note that the proposals for transfer of tax history are not yet enacted and are therefore not covered by the syllabus.

Question 7

The paragraph above addresses the importance of having the correct structure in place when a sale of a licence is foreseen to avoid any unforeseen tax consequence which could hamper the transaction and create significant liabilities for the oil and gas company.

It is important to note that the structure should be considered at the point where the oil and gas company is farming in or acquiring the licence, as most of the times changing that structure after could be difficult or have a tax impact for the company. So, when setting up the initial holding structure for the licence, the tax advisor should also consider a future farm-out or farm-down to an affiliate or third party.

When considering the impact of the sale of the licence, there are mainly two jurisdictions that should be checked for impact (mainly capital gains tax, transaction taxes and corporate income tax). These are the jurisdiction of the company holding the licence and the jurisdiction to which the licenced hydrocarbons belong to (Country licencing the exploration of the hydrocarbons). The first jurisdiction is where the seller of the licence is based and thus any profit can be subject to tax there and the second is where the reserves are based, where the host country could want to tax any profits arising from their natural resources.

There are mainly two ways the transaction can be structured. The first would be a direct sale of the licence by the oil and gas company holding the licence and the second through the sale of the shares of oil and gas company holding the licences (indirect transfer of the licence). For this second transaction, as a general rule, the oil and gas company puts together a double holding structure with two companies. The holding company holds 100% of the shares of the licence holder company so that in a future sale the holding company can sell 100% of the share to the buyer. This structure could vary depending on whether the oil and gas licence country requires the licence to be held by a company resident in its jurisdiction.

These structures could be put in place to try and optimise the tax impacts of a future transfer by eliminating the oil and gas licence country taxation on the direct transfer of the licence. Normally, the holding companies are also set up in jurisdiction with no tax (tax havens) or strong participation exemption regimes and double tax treaty network to optimise any tax due for the sale of the shares. It should be noted that the use of tax haven jurisdictions could trigger the application of any anti-abuse provisions or group policy tax avoidance principles.

Attention should also be paid to domestic rules in the oil and gas licence country. These rules may allow for the taxation of indirect transfers (tracing upwards rules), specifically when the only asset or more than 50% of the assets held by the sold company are immovable property or natural resources held in the in this country. We can see examples of these types of rules in Peru, Angola and Mozambique. If this is the case, even if the transaction is executed through an indirect share deal it may still be subject to tax in the oil and gas licence country under these rules.

In case the oil and gas licence country domestic rules subject the indirect transfer to tax, there is this still possibility of the application of the double tax treaty between this country and the country where the holding company is a resident. Under the double tax treaty provisions, the taxation of gains from the sale of shares (movable property) could be limited to the jurisdiction of residency of the seller, which would avoid taxation for the sale of shares in the oil and gas licence country. However, most double tax treaties will also contain limitations to the sale of companies whose assets are 50% or more composed of immovable property. It is importance to note that all the tests of beneficial ownership, adequate structure and anti-tax avoidance provisions should be met for the double tax treaty to apply.

In the oil and gas licence country, the licence agreement should be checked for any possible exemptions to the transaction, particularly when between group or affiliated companies, or even in cases of restructuring of the group where the intention is not to transfer the licence to a third party.

The analysis of the tax advisor should also focus on potential carried types of transactions, where the acquirer of the licence does not make a cash payment but commits to bear future development costs of the transferor, situation where the transfer does not generate a profit or a capital gain and no tax would be payable and any potential issues with the management of the licence when the transfer is not being done for 100% of the licence rights held by the seller.

Question 8

The main items I would consider on the tax treatment and financial model are:

- Any documentation that would be available with respect to the opportunity, as any model licence or PSC agreement, and other contracts or minutes available where information could be taken on the tax regime applicable.

- Consideration on whether there are any relevant recent changes to the applicable tax regime and how these would apply to the new ventures opportunity.

- The taxes applicable to the opportunity and proposed investment as corporate income tax or special petroleum tax, royalties and signature bonus, rents, technology transfer, etc.

- Rules for the recovery of exploration expenses, treatment of capital expenditure, carry-forward of losses, repatriation of profits.

- Indirect taxation as VAT or sales tax applicable on services and goods and potential refund mechanisms in place in country for the reimbursement of any VAT paid (as normally the sale of hydrocarbons is zero rate in most countries and allows for the recovery of the any VAT paid).

- Possible capital gains tax, transfer taxes or corporate income tax due on future transfers of the assets, licences or agreement to third parties or group companies.

- Customs duties applicable to the importation of the machinery, equipment and vessels necessary for the exploration, development and production work.

- Withholding tax applicable on service payments made to non-resident service providers as a final liability tax, as these are normally grossed up and increase the cost of the investment.

- Tax deductibility restrictions and any taxation or withholding tax applicable on the interest payments from any financing of the project, either by internal group financing or third party independent loans, as well as potential applicable thin capitalisation rules applicable to the financing.

- Whether all the different taxes are correctly reflected in the model and main risks identified with correct sensitivities (e.g. consideration of ring fencing provisions).

- Any transfer pricing rules applicable to any intra-group services or loan transactions and other ant abuse provisions with possible impact on the structure and taxation of the opportunity.