Answer-to-Question-_1_

PART 1

<u>Intro</u>

The three principles regimes for upstream oil and gas operations are tax and concession regimes, Production Sharing Contract (PSC) regimes and service contracts. Each regime applies differing terms to agreements that are concluded between oil and gas companies and host countries/governments.

<u>Analysis</u>

Tax and concession contracts

These operate under a regime where governments transfer the title to oil to the oil and gas companies and impose corporate tax on their related profits. The regime is often combined with a royalty regime meaning that oil and gas companies will be liable tax as well as to royalties based on the value of the oil and gas produced. Examples of tax and concession contracts can be found in tax regimes such as Norway, Canada, Australia, UK, Denmark and the USA (i.e. largely used in developed countries)

Under tax and concession contracts, the oil and gas companies own the oil and gas produced and simply pay taxes on the profits gained from the oil and gas production.

In addition, under such contracts host countries may also impose additional tax or higher tax rates relating to oil and gas production e.g. in Norway with the 50% Hydrocarbon Tax or UK with the 10% Supplementary Charge.

Under such contracts, it is common to find ring-fencing provisions, which ensure that company profits from one field do not offset losses on another field or to ensure that profits from upstream oil and gas activity cannot be offset by losses's on other trade activities.

Such contracts also additional features that allow the oil and gas companies to benefit from incentives such as deductible costs e.g. interest and rules on capital expenditure which are beneficial due to the large capital costs involved in oil and gas exploration and production e.g. 'depreciation uplift'.

The host countries may also have specific domestic rules which allow for oil and gas companies to benefit from tax consolidation or group relief where profits from one company may be offset by losses in a related company, provided specific ownership requirements are met.

Under such contracts oil and gas companies are likely to be liable to withholding taxes on the payment of dividends or the remittance of branch profits as well as additional taxes such as capital gains tax on the sale of oil and gas assets or related companies holding such assets.

Host countries may also impose additional aspects to concession contracts such as resource rent systems.

Production sharing contracts (PSCs)

Contracts concluded under this regime differ from concession agreements, as in this case governments usually retain the title to oil ad gas within the host country and instead enter into PSCs or Production sharing agreements (PSAs) with oil and gas companies in order to give them a right to share production. Here the oil and gas companies derive profit oil (from the production) and recover costs as cost oil. However, similarly to the concession contracts, PSCs are generally combined with royalty regime based on the value of the oil and gas produced.

PSCs are seen in a number of countries and particularly in developing countries such as Angola, Indonesia, Uganda and Egypt.

PSCs vary from country to country and will usually clearly address the issue of how any tax is to be paid - whether by tax is imposed on the profit oil or deemed paid by the government from the government's share of the profit oil.

Service contracts

These differ from the above as they apply where oil and gas companies are simply contractors and do not retain any ownership over the oil and gas produced. Host countries will pay the oil and gas companies a fee for exploration, drilling and production services and the oil and gas company will essentially be a contractor.

The fee under these contracts may increase with increased production but does not give the oil and gas company any entitlement to the petroleum produced.

Service agreements are used in a number of countries such as Iraq, Mexico and Saudi Arabia. They are appropriate where there are confirmed reserves and financial risks are therefore lower.

PART 2

2) **Royalties**
Royalties are payments based on the production or value of oil and gas produced.

Royalties are often paid as part of the regimes mentioned above and come in a number of different variations e.g. fixed percentage royalties (US federal royalties regime), a bid amount (applied in Louisiana state royalties),royalties that change with geological features (Nigeria offshore royalties which decrease with geological features of greater water depth), sliding scale royalties based on production (China), sliding scale royalties based on several factors such as production and price (used in Alberta in Canada) and sliding scale royalties depending on internal rate of return (IRR).

Royalties can be based on fair market prices or deemed prices and depending on the regime, can be paid either to the mineral owner or to host country tax authorities or to a private resource owner.

The advantages of using royalty regime is that they give additional income to the host countries as soon production commences, whereas taxation through concession or PSC contracts may be delated until the oil and gas company is profitable and has used up all carry-forward losses or allowable costs from prior years.

Signature and production bonuses

These are additional terms that may be included as part of oil and gas fiscal regimes. The terms within contracts require that signature and bonuses payments are made at specific stages of the exploration and production.

Signature bonuses are paid on signing oil and gas agreements e.g. on signing PSC or PSA agreements with host countries or on retrieval of block exploration and development licences. They are beneficial to governments who may need the funds to compensate them for costs incurred during the bidding process as well as provide income from government's own oil and gas exploration and administration, especially where they are dry wells.

Production bonuses are paid at various stages of oil production. these can be in the form of capacity building bonuses to assist in development of facilities and infrastructure or bonuses payable on discovery, licence application or specific milestones in production. They will usually be large bonuses payable if oil and gas development is successful.

However, for the oil and gas companies, such bonuses are a disadvantages as they are generally non-deductible or recoverable costs under concession contracts or PSCs.

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Answer-to-Question-_2__

PART 1

1) **INTRO**

The concept of ring-fencing in oil and gas arrangements relates to the where oil and gas companies cannot utilise the profits from one oil and gas field to offset losses on another field. It can be used to relate to where profits from upstream oil and gas activity cannot be offset by losses on other business activities. Essentially, it is a way of separating profits that relate to oil and gas activity, whether between individual blocks/fields or from other non-oil and gas related business activity that a company may carry out. Ring fencing provisions are used in the UK, Denmark, Indonesia and Kazakhstan.

Impact of ring-fencing on taxation

Due to the fact that ring-fencing provisions prevent losses from one oil and gas field to offset profits from another field, this restriction may result in significantly higher taxation being applied to oil and gas companies who cannot utilise losses across their business. For example tax provisions in a given state e.g. UK which prevent non-ring fenced losses from being utilised to reduce taxable profits in the oil and gas operations (ring fenced profits).

In terms of the impact on oil producing states, the ring fencing provisions allow for their to be a clear allocation of profits between oil and gas operations (field by field) and between oil and gas operations vis a vis non-oil and gas business. This allows for appropriate tax revenue to be collected where oil and gas productions are profitable, without causing leakage from this source through the loss relief or tax consolidation between related companies.

PART 2

United Kingdom

The UK has a concession regime. Under the various Income Tax regulations, it imposes corporation tax of 30% on ring-fenced trade (upstream oil and gas activities) while it imposes corporation tax of 19% on non ring-fenced trade. In addition there is a supplementary charge at 10% and 0% Petroleum Revenue Tax (from 1 January 2016).

The ring-fence provisions under these regulation provide that non-ring fenced losses may not offset ring-fenced profits. However, ring fenced losses, may be used to offset non-ring fenced profits. The UK also ensures that transfer pricing rules apply to international transactions and transactions within the UK between ring-fenced and non-ring fenced business e.g. services provided between the two are on 'arms length' terms.

UK companies will often therefore have service companies outside the upstream oil and gas ring-fence regime providing administration, legal, tax advisory, human resources and IT services amongst others.

Denmark

Like the UK, Denmark imposes CIT at a rate of 25%. Ring fence provisions apply so that losses from non-oil and gas activities cannot offset profits from hydrocarbon production (which is taxed under a separate 'Hydrocarbon Tax' system).

Norway

Under the tax and concession regime, Norway applies ring-fencing provisions that apply to a portion of losses. Under these provisions, only 50% of onshore losses may be used to offset offshore profits.

Qatar

Under ring-fencing provisions in Qatar, losses under PSC or other oil and gas contracts cannot be used to offset profits under other PSCs or other oil and gas contracts.

Kazakhstan
Ring-fencing tax provisions apply to PSCs and between oil and gas production vis a vis other business activities.

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Answer-to-Question-_4__

Intro
Permanent Establishments (hereafter referred to as PEs) are defined in the OECD Model Tax Treaty 2017 in Article 5 as *'a fixed place of business through which the business of an enterprise is wholly or partly carried on'*. The definition of a PE includes a place of management, a branch, an office, a factory workshop and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Under Art 5(3), 'a building site or construction or installation project constitutes a PE only if its last more than twelve months'.

An individual or company may also be treated as forming a PE through the activities of a dependent agent who habitually exercises authority to conclude contracts on behalf of the contractor (head country office).

It is key to note however that merely having a representative office, as initially stated in our example, carrying out preparatory or auxillary activities does not fall within the definition of a PE. Therefore representative offices are not caught within the ambit of local taxation as if they are branches.

Therefore, caution must be taken when using subcontractors to carry out services in a number of countries around the world. Care must be taken to consider the various domestic tax laws as well as whether an applicable tax treaty exists between related countries. Provisions of these treaties must be analysed careful as they may define a PE differently from the model tax treaty (art 5 above).

PE Tax considerations faced by oil and gas service companies

In order to ensure that oil and gas service companies do not trigger the formation of a PE, it is key that they take into consideration a number of factors before carrying out activities in the various countries.

Companies providing services such as seismic surveys and drilling may potentially be taxed in those countries where services are performed on the basis that they create a PE.

Consideration must be had as who has the final say over the conclusion of contracts? If the representative office merely advertises the services available and does not have the authority to negotiate or conclude contracts on behalf of its head office, it may not be treated as a taxable PE.

The representative office would also need to take care not to undertake activities that go beyond the scope of its authority and are for example related to sales. A representative office should not there be signing contracts, receiving funds for services and employing staff.

Instead, consideration should be had to the structures that can be utilised in order to prevent PE creation and therefore local taxation as a branch. The contracting stage between the oil and gas companies and the subcontracting service company is therefore of vital importance.

Structure analysis

Sub-contracting

An oil and gas service company operating in the country may want to avoid creation of a PE by further contracting with local joint venture companies to carry out services and thereby limit the local country taxation to the local joint venture company. In this case, the local joint venture company will be fully taxed as a resident entity and there may only be provision for withholding tax to apply towards the fees paid by the oil and gas service company. If tax treaties exist between the two countries involved, there may be provision for lower or nil withholding tax under the treaty.

External consortium

If this structure is utilised the oil and gas service company can avoid creation of a PE by contracting a number of local joint venture companies or the oil and gas operators contract with several independent companies in order to provide the services necessary without creating a PE. The local service consortium will be taxed fully by the local country and only withholding tax will be imposed on the payments made by the oil and gas service company.

Tripartite Agreement

This structure would entail that the oil and gas company contracts with the oil and gas service company which then contracts with a local joint venture company in a tripartite agreement. Such an agreement would limit the exposure to the local joint venture company and ensure that the oil and gas service company does not create a PE. Withholding tax may again only apply to payments to the Oil and gas service company (based aboard) and any tax treaties could apply to reduce or eliminate the WHT.

Where local withholding tax is charged, it is important for the oil and gas companies to consider whether there should be a gross-up clause in their agreements and this must be negotiated at contracting. If so, the service company may be able to recover this WHT is credited.

Other PE considerations include whether the country where the oil and gas service company is operating has domestic laws which treat foreign companies as taxable and not just under a PE. Certain tax treaties may also contain 'force of attraction' provisions which allow host countries to tax income with a source in the country but not derived by a PE in the country, where that income is of the same nature as income derived by PEs e.g. as provided for under UN Model Double Tax Convention.

These are all PE tax considerations that are faced by oil and gas services companies and must be considered well before service companies begin operations in the various countries around the world.

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Answer-to-Question-__8_

Intro

In order to advise the company's board on the new venture opportunity it will be necessary to conduct a tax due diligence on the target and highlight the main tax concerns and gaps that may need to be addressed before proceeding with the investment.

Concerns

Some of the main tax related concerns which would need to be reviewed as part of the tax due diligence would include;

1) Essential taxes that will be applicable to the proposed venture investment including any rules that will apply. These rules would include recovery of exploration expenses, treatment of capital expenditure, availability of carry-forward and carry-back losses, repatriation of profits, capital gains, transfer and exit taxes, indirect taxes such as VAT,

excise and customs duties. In addition to asking; has the target been compliant?

2) Ring-fence provisions and issues that may arise as a result of this for the company i.e. restriction on interest deductions against ring-fence income.

3) Determination of the holding structure - what structure should be utilised to ensure investment is tax efficient. This would include looking whether it is a branch, single company or double company holding structure, consideration of taxation on income flows, withholding taxes, potential capital gains, taxes on exit and funding structure of the investment.

4) Determination of any carry-forward tax losses under a tax and concession regime or allowable costs under a PSC regime and if the transfer of company or asset would preserve such amounts.

5) Determine whether there is provision for group relief, tax consolidation or tax loss contribution available in the new holding structure

6) Consider any transfer pricing implications - reviewing what related party transactions exist especially external funding requirement apply for the investment. Also looking at whether intra-group asset transfers or payments will be at considered arms length.

7) Review and consider whether any interest payments on funds to acquire the new venture would be deductible under local country rules. Reviewing whether the debt and interest deductions can be 'pushed down' to the profitable company (if any).

8) Reviewing whether there is opportunity to increase the value of transferred assets to their market value (asset step up) to allow increased future depreciation deductions, after the acquisition is completed.

9) Reviewing whether the target venture is taxable in its own country of residence or any other country where its assets are located.

10) Consideration of any financing restrictions e.g. thin capitalisation rules in the country.

Financing Model Analysis

In order to provide input on this, we would need to confirm tax rates, depreciation asset balances, tax losses, credits and royalties under concession or PSC regimes. On analysing these, it will be necessary to include the different possibilities of a range of oil and gas finds from the new venture.

From this and together with the fiscal terms reviewed, we will be able to determine the success or failure rate of the new venture and translate this into a conclusion on the possible profit or loss outcomes for the company.

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Answer-to-Question-__6_

Part 1)

The major concern with decommissioning costs is in regards to their treatment - whether deductions are available and the timing of such deductions.

Decommissioning costs may be deductible if they are incurred at the end of the oil and gas field life i.e. usually incurred at a later late and so an annual provision is required for accounting purposes.

The provision however is non-deductible for tax in most countries as the decommissioning expense is only deductible where there is an irrevocable liability to pay the related contractors.

Therefore, decommissioning must be provisioned in the accounts in respect of expenses which may arise in years to come in the future, but no tax deduction is allowed until the actual decommissioning takes place. To address this, oil and gas companies make prepayments of future decommissioning expenses to a decommissioning fund so that deductions can be made over the life of the oil and gas field to match and reflect the provisioning in the accounts.

2) In the UK, HMRC state that a provision is only deductible in accordance with specific rules. These rules state that a provision is only deductible where;

- it is in respect of allowable revenue expenditure and not in respect of capital expenditure. This is based on the case RTZ Oil and Gas Ltd v Elliss
- is in accordance with UK generally accepted accounting principles (GAAP); and
- does not conflict with any statutory rule governing the time at which expenditure is allowed and it is estimated with sufficient accuracy.