THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2024

MODULE 3.04 – ENERGY RESOURCES OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Under a risk service contract, the service company is only entitled to a fee for services performed. These agreements stipulate the procedure and schedule for the performance of and payment for such services. Usually oil companies providing services to host countries are subject to corporate tax.
A pure-service contract is an agreement between a contractor and a host government that typically covers a defined technical service to be provided or completed during a specific period of time. The service company investment is typically limited to the value of equipment, tools, and personnel used to perform the service. In most cases, the service contractor's reimbursement is fixed by the terms of the contract with little exposure to either project performance or market factors. Payment for services is normally based on daily or hourly rates, a fixed turnkey rate, or some other specified amount. Payments may be made at specified intervals or at the completion of the service. Based on our understanding and decades of experience in oil and gas industry our team of oil and gas provides all commercial, financial and technical services for entering into this agreement.

Under a risk service contract, a host nation contracts with a (foreign) oil company to explore and develop its oilfield asset. The oil company assumes all managerial and technical responsibilities and bears all the financial and operational risks, in consideration for a prescribed fee. Despite their differences however, both pure and risk service contracts are similar in that they are agreements for the provision of an agreed upon service in exchange for a pre-determined service fee.

Since the distinction between PSC & RSC can be blurred, perhaps the suggested answer can be a bit more detailed to differentiate PSC & RSC from a typical Production sharing Contract, where contractor shares in the resources produced, and gets reimbursed for its expenditure, and the traditional concession arrangements where title to the oil and gas resources pass to the contractor in the concession, and both the National oil coy (NOC) and the international oil coy(IOC) contribute or acquire equity in the operations, etc.

Part 2

Service contract

Service	Fee (£million)	Cost (£million)	Gross revenue (£million)	Total revenue before tax (£million)	Tax (£million)	Revenue after tax (£million)
Seismic services	100	35	65	65	13	52
Drilling services:						
First 100m	150	50	100 (150 – 50)	165 (65+100)	33	132
150m	250 (150+100)	110 (50+60)	140 (250 – 110)	205 (65 + 140)	41	164

Risk service contract, drilling up to 250 meters depth

Service	Fee (£million)	Cost /cost recovered (£million)	Total revenue before tax (£million)	Tax (£million)	Revenue after tax (£million)
Seismic services	100	35	100		
Drilling services:					
First 100 Meters	150	50	250 (100 +150)	50	200
150 Meters	250	110	350 (100 +250)	70	280
200 Meters	350	170	450 (100 + 350)	90	360
250 Meters	550	250	650 (100 + 550)	130	520

Question 2

When an oil and gas company have significant production coming from their ongoing project it should consider the set-up of a group company for the trading of the oil and gas. This will significantly optimize the cost of using a third-party oil trader, thus ensuring, or securing that the margin or fee charged by an independent third party is kept in the group's profits. The trading company will have the objective of not only purchasing and selling the hydrocarbons at spot prices but also entering forward and option contracts to allow the use of the best possible prices on acquisition and sale of the product and arranging insurance, delivery, and funding when the required.

Given the nature of the profitable activity, oil and gas company normally choose to set-up an independent company in a low tax rate jurisdiction or a country where the setting up of trading companies is incentivised through specific regimes or benefits. This will allow the profits from the provision of trading services to be taxed at rates lower than the application in the host jurisdiction or in the country where the oil and gas company is a resident.

However, it is very important that the planning takes into consideration the required economic substance to pursue this activity and make sure the trading company is properly staffed to deliver the proposed services. This will include local directors, traders, trading supervisors, transaction execution, risk, performance, and capital management. The compliance with the necessary economic substance requires not only that these workers are localized in the trading company jurisdiction but that effectively the decisions and meetings are taken and held in the country. Some of the other supportive services, like IT and HR, may be provided by other group companies under service agreements as they are less linked to the trading profits.

Switzerland is the world's most used country for this type of activity and is where some of the world biggest trading companies are located (e.g. Vitol and Glencore). In this jurisdiction, the trading company normally use the mixed company regime requiring that the company has its profits arising predominately from foreign activities (around 80%). IF this is the case, companies can achieve an exemption between 75% to 90% from Swiss tax, resulting in effective tax rates between 9% and 11%.

Singapore has been an up-and-coming jurisdiction for trading companies to set up in since 2001. The Government has put in place a Global Trader Program offering a corporate tax rate of 10% to traders which can be reduced to 5% if certain conditions are met (e.g. hiring levels and use of national banking facilities).

The main tax and planning issues to consider with these trading company structures are transfer pricing given that oil and gas companies normally set up these companies mainly to trade their oil. So, attention must be paid to finding comparable transactions to assure that the trading activity is complying with the transfer pricing principles and market prices. This may be difficult to achieve in a situation where the host country oil and gas agreement or PSC impose a specific sales price (e.g. Norway) for tax assessment and TP purposes. Concerning Switzerland, one major issue is whether the granted benefits to the trading company may constitute state aid and be contrary to EU agreements with Switzerland. Also, in case a new company is set to begin the trading activity with the absence of prior experience in the sector, it may become difficult for the company to secure other business from third parties as normally sector experience is required and a commercial guarantee which, where the company has no assets may represent an obstacle to obtaining business.

Options

This derivative constitutes a right to purchase or sell oil or gas later. You can have two types of options: A call is the option to purchase later, and price and a put is the option to sell later and price. The person writing the option normally charges an option premium or fee. Main tax considerations are whether the option premium is subject to tax and the moment when tax is paid as, in some countries, this taxation can be delayed to the future sale of the oil or gas acquired with the option.

Forwards and futures

This instrument is also a right to purchase or sell at a specific later date. The difference from an option is that there is no contingency or choice as to whether to buy or sell, thus there is no option on whether to exercise it or not. These derivatives can be openly traded on security exchanges and sold before the forward date arrives. The main tax consideration on these instruments is the understanding of whether the gain or loss is taxed as accrued or only when exercised which may vary from country to country.

Plain vanilla swaps

This derivative is intended to exchange financial instruments between two parties, normally, the cash flow arising from one financial instrument is swapped with the cash flow of the others party financial instrument. This instrument is mainly used for hedging transactions where oil and gas companies want to limit or cap their risk wither on interest rates, oil prices or foreign currency exchange. This is very significant for companies who do not report in USD as the oil and gas price world markets run on USD only. To execute the swap parties normally use a notional principal amount basis.

Special swaps (credit default and total return)

Credit default swaps aim to provide insurance for a company defaulting in their loan obligations and the total return swaps are an instrument where the holder of the swap can obtain the income and capital gains from an investment without having to hold the investment directly. This may be used in situations where there are specific limitations to holding that investment (e.g. Chinese equity or private companies). The main tax considerations for swaps are withholding tax on payment to non-residents as the instrument may not be qualified as an interest payment in some jurisdictions.

PART B

Question 3

Part 1

Public ownership of mineral resources may conceive as national ownership, and as such be subject to every kind of 'nationalist' policies: national companies are an essential tool in this regime. Under this type of governance, access to land or sea is only granted if the expected profits and fiscal revenues are considered satisfactory by both investors and the owners of the mineral resources. The main concern of the proprietor is not to allow free access to his land/sea. Royalties are an essential tool within this regime; this is to prevent a unit of production being lifted without rent being paid.

The proprietorial regime allows mineral owners to dispose of their resources as they see fit, and to secure the maximum possible payment for granting companies access. Furthermore, this model allows mineral owners to make their own decisions regarding the development and exploitation of resources and to deploy tools that will allow the maximum rent. Different devices may be used for collecting ground rent to secure a higher take at each level of the investment process. These might include higher royalty rates, various bonuses that may be scattered over the contract period, higher income taxes and excess-profit taxes; national oil company (NOC) plays key roles under these regimes in securing higher rent and in controlling the extraction and distribution of national mineral resources (Mommer, 1994). The key aim of the proprietor is to collect a significant rent for every unit lifted, with the usual focus being on levies on gross income.

Part 2

Students are expected to discuss structure of PSA and make matches between features of PSA and features of a proprietorial regime.

Under a PSC, a state (the State) contracts with an international (and in some cases a domestic or another state's national) oil company (IOC) for the IOC to provide the requisite finance and technical skills in order to explore for (and hopefully produce) oil and/or gas.

The State will usually be represented by the government or a government body, such as the national oil company (NOC), who will take delivery of the State's share of production.

The IOC is granted an exclusive right to explore and produce oil and gas within a defined area (generally known as the contract area) and, in doing so, bears the entire risk of the project, financial and otherwise.

Should a commercial discovery be declared, the IOC becomes entitled to a portion of any oil produced as 'payment' for its efforts (generally at the end of the quarter in which the oil is produced), in addition to recouping its costs out of production; conversely, if no discoveries are made, the IOC receives nothing.

The State retains ownership of all oil and/or gas produced (subject only to the IOC's entitlement to a portion of any oil produced on a successful discovery).

The extent to which the NOC is involved with the exploration and production process varies from country to country.

There are typically four key financial aspects to a PSC:

1) Royalty: Firstly, the IOC is often expected to pay a royalty on gross production to the State. The royalty is often, at the State's election, taken 'in kind' (that is, a share of production) or by way of a payment equivalent to the sale price of the State's royalty share of production.
2) Cost oil: Following payment of any royalty, the IOC is entitled to a pre-determined percentage of production from which it may recover its costs (with any costs not recovered carried forward to the next period). Such production is known as cost oil.
3) Profit oil: The oil remaining after the royalty and cost oil (known as profit oil) is divided between the IOC and the State in accordance with the production sharing provisions in the PSC. It is often the case that the State's share of profit oil increases as production increases.
4) Income tax: Finally, the IOC usually has to pay income tax on its share of profit oil. However, this income tax is often paid by the NOC or State on behalf of the IOC, such that there is no financial impact on the IOC.

Question 4

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 rule, the oil and gas company put 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 optimize 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 optimize 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 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 important 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.

PART C

Question 5

Part 1

An ETS – sometimes referred to as a cap-and-trade system – caps the total level of greenhouse gas emissions and allows those industries with low emissions to sell their extra allowances to larger emitters. By creating supply and demand for emissions allowances, an ETS establishes a market price for greenhouse gas emissions. The cap helps ensure that the required emission reductions will take place to keep the emitters (in aggregate) within their pre-allocated carbon budget.

A carbon tax directly sets a price on carbon by defining a tax rate on greenhouse gas emissions or – more commonly – on the carbon content of fossil fuels. It is different from an ETS in that the emission reduction outcome of a carbon tax is not pre-defined but the carbon price is.

Part 2

Ref. the 2021 OECD report:

- Limiting the adverse consequences of the major environmental challenges.
- Reaching greenhouse gas abatement goals.
- Tax policy can create incentives to reduce greenhouse gas emissions through favourable treatment of environmentally appealing technologies or behaviours, and by pricing greenhouse gas emissions.
- Tax and fiscal policy has a key role to play in shaping the distributional impact of environment policy.
- Transfers or other flanking tax reforms can make reforms progressive and increase energy affordability.

Question 6

Part 1

Ring fencing imposes a limitation on deductions for tax purposes across different activities or projects undertaken by the same oil and gas company. This forces contractors or concessionaries to restrict all cost recovery and or deductions associated with a given license (or sometimes a given field) to that particular cost. This means that all costs associated with a particular block or licence must be recovered from revenues generated within that block.

Ring fencing can be applied on different scopes. Some countries ring-fence their oil and gas activities from other 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 company. Thus, the ring fence may be individual licenses or on a field-by-field basis. In a ring fencing situation exploration expenses in one non-producing block could not be deducted against income for tax calculations in another block. Under Production Sharing Contracts normally ring-fencing acts in the same way as cost incurred in one ring fenced block cannot be recovered from another block outside the ring fence.

Part 2

The impact of ring fencing in the taxation of oil and gas companies is that it may lead to a higher tax on the projects. If a company operates in several ring-fenced areas it has to calculate profits separately for each of them and cannot consolidate them for tax purposes.

If all the projects held by the company are economic profitable it would only constitute a timing 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 governments these rules have impact because the absence of ring fencing 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 taxable income.

By introducing ring fencing the government revenue will be accelerated.

If no ring fencing applied this would potentially reduce the (higher) taxes intended to be collected from those operations.

If there is no ring fencing and different tax regimes apply to different areas, companies could allocate costs disproportionately to higher taxed areas to reduce tax.

When countries impose progressive taxes, area ring-fencing can mean that 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 country as a whole.

Ring-fencing adds significant administrative complexity and risk, particularly when license areas or even individual projects are ring-fenced, as is true in many countries.

Ring-fencing may hamper companies undertaking further exploration and development activities due to the inability to claim deductions for such activities on new projects.

It may also encourage tax planning if the ring-fenced tax regime is more onerous than the standard tax regime.

Question 7

Interest deductions are generally allowed to a company for the purchase of assets under tax and concession regimes, as the assets will generate taxable profits. It may be harder to achieve interest deductions for the purchase of shares in a target company, as there may be restrictions where the related dividends are tax-exempt under participation exemption provisions.

Interest deductions can be used against profits of the acquired company if the country allows the use of tax groups or tax consolidation under its domestic rules.

The possibility of using interest deductions in PSC regimes is harder to achieve. Generally, the PSC should exclude financing costs as allowable costs in determining cost oil. Interest deductions on debt to acquire licence interests subject to PSC regimes can also be made elsewhere in the multinational group.

The existence of thin capitalization provisions can restrict or limit interest deduction on related-party debt making harder to obtain tax utilization of the interest expense.

Debt push down is achieved by the placing of third-party debt within a multinational group, such as borrowing from banks. In some jurisdictions, interest on this debt may be outside the scope of thin capitalisation provisions.

The objective here is to use a debt push down structure to utilise interest deductions in a target Company to offset that company's profit.

The acquiring company may obtain a tax deduction in its own country but without being able to effectively utilize the deductions if it does not have significant taxable income.

To push down the debt, the acquiring company incorporates a new company in the target country (SPV). The SPV then purchases the target company, or the oil and gas assets, on behalf of the acquiring company.

If the target company is acquired, then tax consolidation is generally needed to transfer accumulated tax losses arising from interest deductions in the SPV to reduce tax in target company.

The timing of adding debt and related interest deductions is important depending on the stage at which the upstream oil and gas target company is. If in exploration or early production stage, with large carry-forward losses, there may be an advantage in increasing related party debt at a later stage when the target company is profitable, and deductions can be utilised.

Question 8

In fact, the long lead time and upfront investment of oil and gas project may create a substantial amount of losses in a jurisdiction where an oil and gas company have a specific project or licence. Generally, these losses are recoverable, either through a cost recovery regime or as accumulated tax losses in a corporate tax system, if the project reaches production phase and can generate enough profits to offset the investment made by the oil and gas company.

However, reaching a production phase may take several years to materialize (normally between 5-10 years), meaning the recovery of the accumulated costs may take a long period of time to recover fully. The impacts of the big temporary differences between investment and recovery could also lead to significant cash flow impacts to the company.

A possible structure that may be used to overcome this limitation is the utilization of a branch structure, where possible, where the head office, or a tax group to which the company is part of, generates enough profit against which these initial losses can be deducted.

This is only possible in situations where tax laws of the head office's jurisdiction company allow for the consideration of branch expenses to be considered in the tax calculation of the company because the company and its branch are the same legal entity.

This will not be possible where the head office jurisdiction tax laws treat the branch income and losses as exempt in the origin country. Some countries allow each taxpayer to elect which system they prefer for the treatment of their branches' income and costs, an exemption or taxation of income.

It is important to note that, where the head office jurisdiction allows for the utilization /of the losses under the head office company tax assessment, future income and profits obtained by the branch will also be subject to tax, even if it has already been subject to tax in the host country jurisdiction.

This may create double tax situations if a foreign tax credit is not available at the head office's jurisdiction under the domestic tax law or double tax treaty entered between the two States.

The use /of early utilization of the losses accumulated in the host country under these circumstances may constitute a major cash flow advantage by lowering the taxation of profits obtained in the head office's jurisdiction in which it will only be subject to tax when the oil and gas project generates income. Also, should the project never reach a production phase, this structure will allow a definitive tax efficiency for the losses.

The Marks & Spencer EU case jurisprudence and its subsequent analysis by the European Court of Justice on the recognition of final losses of foreign subsidiaries may also be relevant for oil and gas companies' resident in the EU, particularly in situation where the foreign branch is wound up after unsuccessful exploration, even in a case where the head office jurisdiction applies an exemption system for branch income and losses.

The "check the box" system applicable in the US may also be relevant for oil and gas company resident in the US.