THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 3.04 – UPSTREAM OIL AND GAS OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Export Duty

Export duties on oil and gas are taxes on amounts of production exported from the producing country. They are generally combined with other taxes, as in the following example for Russia:

- A substantial portion of the Russian income from upstream oil and gas is made under the Export Duty regime at rates from 35% to 60% on crude oil, and natural gas at 30%. There is no export duty on LNG.
- The Russian government also imposes Mineral Extraction Tax, which are royalties based on crude oil RUB 446 per tonne, natural gas RUB 509 per 1,000 cubic metres, etc.
- Russia also imposes Corporate Profit Tax at 20%.
- The Russian government has provided exemptions from export duty for crude oil with specific characteristics, and in relation to production from specific regions.

Export duties are substantially different from indirect taxes such as VAT, which may provide exemption for exports.

The duty is imposed for the right of the country’s oil and gas, rather than as a tax on production as VAT.

The amounts are imposed as an export duty so that domestic oil and gas prices are not directly affected, and therefore target large scale oil and gas developments aimed at generating profits from international oil and gas sale.

The issue of oil and gas developments impacting local prices is seen in a large number of countries. For example the United States, where the potential issuing of LNG export permits and terminal approvals is expected to increase US domestic prices. The use of an export duty may partially address this issue by ensuring that part of the taxation does not apply to domestic oil and gas sale.

Indirect Taxes and VAT

Value Added Tax (VAT) is imposed in many countries on the value of a company’s sales, with the company allowed a credit for VAT paid on their purchase. VAT therefore applies to the value added by each stage from production to final sale.

The export of oil and gas may be ‘zero rated’ for VAT purposes. The result is that VAT is not chargeable on the export sale, however the company is entitled to a refund of the VAT paid on its related purchase. Zero rating may then result in a credit refund issue.

The oil and gas company may be applying for refunds, as it has paid VAT on its purchases, but does not charge VAT on its sale where export sales are zero rated. The issue is whether refunds are allowed, are provided promptly, or there are substantial delays.

There may also be an issue that VAT refunds may be restricted to the related joint venture, rather than made available to the investing companies.

Tax regimes and PSCs may therefore provide specific exemptions from VAT to avoid this credit refund issue. This may be extended to local suppliers to upstream oil and gas companies.

Alternative methods of indirect taxation include the gross turnover taxes applied in many states in the United States. These are essentially single stage taxes on the final sale to the consumer.

Countries may also impose significant customs duties on importation of equipment for exploration and production. Several countries allow specific exemption under PSCs or tax regimes from indirect taxes such as VAT where equipment used in oil and gas activities is subsequently exported after use. Examples: The Brazilian Repetro regime, and the Indonesian Import duty.

Customs duties are a significant issue for the importation of oil and gas, and a related issue is whether there are exemptions from customs duty under international agreements. Examples: the related exemptions between Canada, Mexico and the United States under the North American Free Trade Agreement.

Related issues include whether crude oil and natural gas qualify as sources in a NAFTA country under NAFTA rules of origin. For example, when oil and gas companies blend crude oil with condensates or diluents from non-NAFTA states to transport the oil by pipelines, or blend natural gas with gas origination in non-NAFTA states.

Question 2

Oil and gas trading

When an oil and gas company has 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 into 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 at a later date. You can have two types of options: A call is the option to purchase at a later date and price and a put is the option to sell at a later date 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

Country Tax Regimes

The UK imposes ring fenced corporation tax on profits from all upstream oil and gas activities, referred to as the 'ring fenced' trade at 30%.

The UK allows an indefinite tax loss carry-forward, and a one year carry-back of losses.

The transfer pricing rules apply to international transactions and transactions within the UK.

The ring fencing provisions provide that onshore losses may not offset offshore profits.

There is a first year capital allowance of 100% for capital expenditure from the ring fence trade. The allowance do not apply to exploration costs, however the research and development allowance at 100% may apply.

Tax consolidation, known as group relief, is allowed for corporate tax and supplementary charge purposes between companies with 75% common ownership.

The corporation tax rules can limit interests' deductions using a transfer pricing approach requiring 'arm's length' terms. Interest deductions may also be limited under world-wide debt cap rules, but these do not apply to ring-fence companies.

Supplementary charge regime

This regime applies to ring fence profits accruing from 17 April 2002. The current rate of SC is 10% which has been reduced from 20% with effect from 1 January 2016. SC applies on a company's ring fence profits but no deductions are permitted for finance costs. The Supplementary Charge, however, may be reduced by various allowances such as the investment allowance, cluster area allowance or onshore allowance. The effective tax rate of corporation tax and supplementary charge is 40%.

Petroleum revenue tax (PRT) regime

This older regime is a field-based tax, introduced under the Oil Taxation Act 1975 at 75% rate. PRT was a charged on "super-profits" arising from the exploitation of oil and gas in the UK and the UK's continental shelf. PRT is charged by reference to individual oil and gas fields, so the costs related to developing and running one field cannot be set off against the profits generated by another field. It is a charged on profits arising from oil and gas production from individual fields which were given development consent before 16 March 1993 – PRT was abolished for all fields approved for development thereafter and it was reduced to 50% for paying fields. The rate of PRT is 0%, having previously been reduced from 50% to 35% in 2015. PRT is deductible as an expense for the purposes of calculating Ring Fence Corporation Tax and the Supplementary Charge.

Question 4

Stabilization clauses

The IOCs have been using and requesting stabilization clauses in oil and gas contracts as a protection tool of the investment made in a host state which is long term and high risk. The purpose of the stabilization clause for the IOCs is to create a legal or tax enclave that renders any future change in law ineffective against the oil and gas company forecasted revenue. For the host state, the benefit of stability clauses is to encourage investment by providing the investor with stability assurances as being seen as a country with an unstable fiscal regime may negatively affect the confidence of investors in government policy.

In theory, the clauses allow investors to invoke the contract entered into between the parties to guarantee the tax framework agreed at the time of the contract is applied and even sue the host state if it fails to honour the agreement or the stability clause.

There are two ways that stabilization clauses can work. The stabilization clause may (i) freeze the tax framework at the time of signing of the contract guaranteeing that the tax regime will continue for a specified period. These are commonly referred to as freezing stability clauses, or (ii) compensate the IOC for any changes to the stabilized tax framework. These are commonly referred to as economic stabilization clauses.

In the economic stabilization clauses, changes to legislation affect the investment but in that case, the parties may adjust other aspects of the contract (e.g. production allocation) to compensate for the return lost by the introduction of the new laws. This adjustment would obtain a rebalance of the contract economic terms.

It should be noted that the mere inclusion of these provisions in oil and gas contracts is not sufficient to attain the desired result. In the context of a dispute between an IOC and a state, the latter may render this clause ineffective by using its sovereign power to deny the IOC the desired protection.

These types of clauses may potentially also have administrative challenges as keeping track of the stabilized tax regime and the effective way to compensate companies when new measures affect the return of the investment. Other problems to mention are possible hurdles for host states when trying to introduce a reform of the tax regime applicable to oil and gas contracts as the reforms could only apply to future agreements and create different tax regimes for oil and investment depending on the time the contract was agreed.

Because of the issues mentioned above these types of clauses have been considered to be very intrusive of the sovereignty powers of host states and are becoming more difficult to accept in the negotiation of contracts.

When an issue with the stability clause arises the IOC have the option of relying on the national courts or international arbitration to uphold its contractual rights.

PART C

Question 5

Merger and Acquisition

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 more difficult to obtain interest deductions to purchase shares in a target company – there may be restrictions where the related dividends are tax exempt under participation exemption provisions.

Interest deductions may be used against profits of the acquired company if the country allows tax grouping or consolidation.

The effective use of interest deductions in PSC regimes is more difficult. The PSC itself will generally exclude financing costs as allowable costs in determining cost oil. The issue may then be whether interest deductions on debt to acquire licence interests subject to PSC regimes can be made elsewhere in the multinational group – at a parent company level.

A number of countries have thin capitalisation provisions which restrict interest deduction on related party debt.

The debt push down issue more frequently related to the placing of third party debt within a multinational group, such as borrowing from banks, and in many countries interest on this debt is not subject to thin capitalisation provisions.

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

Tax Analysis

Purchaser Company may obtain a tax deduction in its own country. However, it may not be able to effectively use the deductions if it does not have significant taxable income. The ability to use tax deductions is generally known as 'tax capacity'.

Purchaser Companies use a new company in the target country, usually called a special purpose vehicle (SPV). The SPV then purchases Target Company, or the oil and gas assets, on behalf of the purchaser Company.

If the target company is acquired then tax consolidation is generally needed to transfer tax losses arising from interest deductions in the SPV to reduce tax in Target Company. It is necessary that the related country has some form of tax consolidation.

Consolidations

Care is needed with the timing of adding debt and related interest deductions. An upstream oil and gas target company may be in exploration or early production stages, with large carry-forward losses. There may be an advantages in increasing related party debt at a later stage when the target company is profitable, and when the deductions can therefore be utilised.

Question 6

Decommissioning

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 limits varies, deductions for prepayments generally cannot extend much beyond a one-year period.

In the United Kingdom, the 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.

Question 7

Profit repatriation and planning

The analysis includes the structures to obtain interest deductions, generally known as 'debt push down', and the issue of the limitation on interest deduction under most PSA 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 a depreciable asset, generally known as 'asset step up' to increase future depreciation deductions.

Tax losses 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 under the 'participation exemption' provision operating in many EU countries. A share transaction requires greater due diligence as the buyer will acquire the company together with all its liabilities.

Farm-out/farm-in arrangements may be used, where the investor agrees 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 issues 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.

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 that 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 buyer, the tax team's input to financial modelling for the investment, materiality levels for reporting tax issue to the acquisition team, and the effects of the acquisition on the accounts and deferred tax balances.

Question 8

Leasing in upstream oil and gas

In the oil and gas industry, lease operations are used mainly as a source of financing by the company to avoid having to advance the funds to acquire expensive equipment or vessels. Leases may be broadly qualified as finance leases or operational leases depending on several factors where one of the most important ones is whether the lessee gains ownership of the asset at the end of the lease.

The accounting and tax qualification of a lease may not be similar. For tax purposes, the qualification of a lease will normally depend on factors such as ownership of the asset, lease term when compared to the economic life of the asset (normally percentage-based, e.g. the Netherlands) and the existence of purchase options. As to the accounting qualification, guidance is in the International Accounting Standard 17.

As a general rule, a finance lease will lead to the recognition of debt on the balance sheet of the company, similarly to a loan for the acquisition of a tangible asset and for tax purposes only the interest portion of the lease payment is tax-deductible. The company will get a depreciation deduction on the value of the asset. On an operating lease, for accounting and tax purposes the transaction is qualified as a rental operation, meaning that the company will get a full deduction for the total amount of the lease payment.

From a tax perspective, the qualification as an operating lease is usually more beneficial as the full deduction of the rental payments leads to a faster deduction of the total cost than a combination of the immediate deduction of the interest payments combined with the depreciation deduction of the asset over its useful life. Exceptions to this rule may be when the depreciation rate and interest rates on the lease are very high.

The operating lease also has the advantage of not leading to the recognition of additional debt elements in the balance sheet of the oil and gas company, which may be seen as a weakness by investors.

In oil and gas leasing operations, we normally see cross border leasing operations and payments because the equipment is needed in the jurisdiction where the company holds the Licence/PSC. Therefore, attention must be paid to withholding rates applicable to the lease payments, the qualification, like royalty or interest, given under domestic law and the possible application of a double tax treaty to minimize the withholding tax impact.

Detailed attention should also be paid to VAT impacts of the transaction on whether VAT may apply and not benefit from an exemption on the selling price of the asset or the rental payment and in that case whether a credit or refund is available. Other tax impacts on leases include possible stamp tax on the documentation (e.g. mortgage/guarantee) or customs fees for importation as well as thin capitalization limitations from the additional debt.

A Sale and leaseback agreement is where an oil and gas company sells an asset to another group company or independent lessor and then leases the asset back from the buyer. Sale-leaseback operations are normally qualified as an operating lease. This structure applies to immovable property or equipment. This operation is an alternative to a normal financing operation and allows the seller to access funds for its investment operations without losing the use of the equipment or the property. The intervention of the lessor is a reward through the payment of rental payments throughout the life of the leaseback. So, the oil and gas company can access value that would otherwise be tied to the property or asset.

From a tax perspective, given the usual qualification as an operating lease, the oil and gas company will be able to expense the total amount of the rental payments which, as a general rule, would be higher than the depreciation deductible as the owner of the asset. It may also be the case where the asset would already be fully depreciated and therefore would be no depreciation deduction left. However, it is important to analyse the tax impact of the initial sale of the asset to check whether any capital gains or other types of tax on exit could apply which would diminish the attractiveness of the operation. The existence of previous tax losses carried forward that would otherwise expire can be relevant for the analysis of the tax optimization of the transaction.

A sale and leaseback operation may also be entered into between two related parties (e.g. companies from the same group). Normally this is done through the incorporation of a leasing company in a tax-effective jurisdiction for holding of assets (e.g. Singapore). This leasing company would hold all the main high-value assets of the group paying less property tax and would lease the assets to the operating companies in need of said asset shifting profits to this lower tax jurisdiction and keeping the expenses in the jurisdiction where the tax rate is higher. This normally occurs with vessels or FPSO that have a very high value. In these structures, attention must be paid to possible anti-abuse provisions requiring the leasing company to have economic substance and the existence of a full leasing business with directors, staff and capital.