

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2024

MODULE 3.04 – ENERGY RESOURCES OPTION

SUGGESTED SOLUTIONS

PART AQuestion 1

	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>
Signature Bonus	-100,000			
Depreciation Charges	-1,000,000	-1,000,000	-1,000,000	-1,000,000
Pre-Production E&E costs	-1,000,000			
Production costs		-200,000	-200,000	-200,000
Oil Production (Barrels)		800,000	900,000	1,000,000
Royalty 10% - in Kind		-80,000	-90,000	-100,000
Oil after Royalty		720,000	810,000	900,000
Oil Price £		40	42	44
Value of Oil £		28,800,000	34,020,000	39,600,000
Cost Oil £:				
Cost Oil - Pre-Production Costs £		-1,000,000		
Profit Oil Total £		27,800,000	34,020,000	39,600,000
Profit Oil Split £				
Lucy Oil 40% £		11,120,000	13,608,000	15,840,000
XYZ Host Country 60% £		16,680,000	20,412,000	23,760,000
<u>Lucy Oil after tax profits</u>				
Revenues from oil		11,120,000	13,608,000	15,840,000
Allowables pre-tax deductions				
Depreciation		-2,000,000	-1,000,000	-1,000,000
Annual Production Costs		-200,000	-200,000	-200,000
Profit before tax		8,920,000	12,408,000	14,640,000
Tax @ 20%		-1,784,000	-2,481,600	-2,928,000
Profit After Tax		7,136,000	9,926,400	11,712,000
Total Profit 2020 - 2023	28,774,400			
Less Signature Bonus	-100,000			
Net Profit 2020-2023	28,674,400			
<u>XYZ Host Country Revenues</u>				
Signature Bonus	100,000			
Royalty (in kind X Price)		3,200,000	3,780,000	4,400,000
Profit Oil		16,680,000	20,412,000	23,760,000
20% Tax Revenue		1,784,000	2,481,600	2,928,000
Annual Revenues £	100,000	21,664,000	26,673,600	31,088,000
Total Revenues 2020-2023 £	79,525,600			

Question 2

Tax treaties play a vital role in facilitating cross-border investments in the extractive industries, especially for oil and gas projects. Their core objectives include eliminating or reducing the risk of double taxation, encouraging foreign direct investment, and ensuring a fair allocation of taxing rights between the source and residence countries. Tax treaties also provide mechanisms to resolve disputes and offer legal clarity to investors, which is critical in large, capital-intensive extractive projects. However, the application of tax treaties in the oil and gas sector presents unique challenges due to the long-life cycle of extractive investments, uncertainty in the industry, and differing domestic tax policies.

Extractive investments, particularly in the oil and gas sectors, are heavily capital-intensive, requiring substantial initial investments with long periods before returns are realized. Tax treaties significantly influence the financing decisions for these projects, primarily through provisions that reduce or eliminate withholding taxes on cross-border payments of dividends, interest, and royalties.

One critical distinction in financing is between debt and equity. Interest on debt is generally deductible, while dividend payments on equity are not. This makes debt financing attractive, but the withholding taxes on interest payments can create additional costs for investors. Tax treaties often reduce or exempt withholding taxes on interest payments, making debt financing more viable. For instance, under certain treaties, interest paid to a parent company, or affiliated entities may benefit from a reduced rate, enhancing the project's post-tax returns. In contrast, equity financing is commonly used during the exploration phase when income generation is minimal, and investors cannot service debt.

Tax treaties that reduce or exempt withholding taxes on dividends make equity financing more attractive during the project's initial stages. Additionally, tax treaties may impact the overall ownership structure of extractive projects, as they influence how and where the parent company is tax-resident, guiding the selection of the optimal tax jurisdiction. Many international lenders require tax gross-up clauses to be included in financing agreements, ensuring that lenders receive the full interest payment without any deduction for withholding taxes. In such cases, the borrower must absorb the cost of the withholding taxes. Tax treaties that reduce withholding taxes on interest payments can directly lower the borrower's cost of capital. For instance, if a tax treaty reduces the withholding tax on interest from 30% to 10%, the gross-up clause's burden on the borrower is significantly lessened.

Capital gains taxation is another critical area where tax treaties can impact investment decisions. In many countries, capital gains on the sale of shares or interests in oil and gas projects are subject to tax, especially when the project's underlying value is derived from immovable property such as mineral rights. Some countries, like Australia, Canada, and the U.S., have domestic rules that impose capital gains tax on non-residents disposing of interests in real property. Tax treaties may provide clarity and relief from capital gains taxation by limiting the source country's right to tax certain transfers of shares or interests in extractive projects. For instance, a treaty may specify that capital gains arising from the transfer of shares in a company are only taxable in the investor's country of residence, unless the company derives most of its value from immovable property in the source country. However, if the source country retains taxing rights under a tax treaty, capital gains may still be subject to tax, but the tax treaty can offer relief by allowing the investor to offset the tax paid in the source country against their domestic tax liabilities, reducing the risk of double taxation.

Another common challenge is indirect transfers, where a foreign parent company sells an interest in a subsidiary holding an extractive asset in the host country. Some tax treaties specifically address indirect transfers by allowing the source country to tax such gains, particularly when most of the asset's value is derived from immovable property. However, a well-negotiated treaty may provide exemptions or lower tax rates, thus mitigating the deterrent effect of high capital gains taxes on investment transfers.

Withholding taxes apply to various cross-border payments such as dividends, interest, royalties, and service fees. In extractive industries, these payments occur throughout the life cycle of a project, making withholding taxes a significant concern for investors. Tax treaties are instrumental in reducing the rates of withholding tax on these payments, which directly affects the project's cash flow and overall profitability. In the early stages of a project, withholding tax on interest payments may be a significant burden, as projects often require large amounts of debt financing. Tax treaties that reduce the withholding tax on interest paid to non-residents can significantly reduce the cost of borrowing. For example, under the OECD Model Convention, the withholding tax on interest can be reduced to as low as 5%, depending on the treaty partner.

Dividends are typically taxed both at the source and in the investor's country of residence. Tax treaties often reduce the withholding tax on dividends, especially when the investor holds a substantial equity interest in the project. For instance, a treaty may lower the dividend withholding tax rate from the domestic rate of 20% to 5%, which enhances the post-tax returns for shareholders.

Royalties paid for the use of technology, intellectual property, or specialized services in oil and gas projects are another area where tax treaties provide relief. High withholding taxes on royalties can discourage the use of advanced

technology and expertise, critical for the success of extractive projects. Tax treaties that limit withholding taxes on royalties encourage the inflow of foreign technology and expertise by reducing the tax burden on these payments.

Despite the benefits of tax treaties, there are several challenges and limitations for investors in the extractive industry. Tax treaties are negotiated on a bilateral basis, and their provisions can vary significantly. Investors must carefully navigate different treaties to optimize their tax position, which can be complex and time-consuming. In some cases, conflicting interpretations of tax treaties by different countries can lead to double taxation, particularly regarding the allocation of taxing rights over capital gains or service fees. In developing countries, domestic tax laws may be unclear or inadequately enforced, leading to disputes over the application of tax treaties. In such cases, the treaty may not provide the expected relief, and investors may face unpredictable tax outcomes.

PART B

Question 3

Part 1

A carbon tax is “an instrument of environmental cost internalisation. It is an excise tax on the producers of raw fossil fuels based on the relative carbon content of those fuels. Under a carbon tax, the government sets a price that emitters must pay for each ton of greenhouse gas emissions they emit. Businesses and consumers will take steps, such as switching fuels or adopting new technologies, to reduce their emissions to avoid paying the tax.

A carbon tax could discourage the use of fossil fuels and encourage a shift to less-polluting fuels, thereby limiting the carbon dioxide (CO₂) emissions that are by far the most prevalent greenhouse gas. By placing higher taxes on carbon-based fuels industries can reduce the level of pollution and look to alternatives like solar power and hydrogen engines, which have lower impacts on the environment. The implementation of a carbon tax system, therefore, provides an incentive for businesses and industries to develop more environmentally friendly production processes. The taxing of GHG emissions encourages investment in renewable energy and leads to further technological developments.

Part 2

Students are expected to discuss four benefits. Examples of these benefits are:

- **Reduce Carbon Emissions:** By attaching a significant price to pollution, it incentivises shifts towards less carbon intensive fuels, deployment of energy efficiency measures, and investment in clean alternatives across sectors like electricity, transportation, and manufacturing.
- **Mitigate Climate Change:** It provides a continuous incentive for reducing emissions – including through innovation in green technologies – while generating revenues that can be reinvested and used for social transfers. With carbon taxes, in contrast to regulation, companies can make a choice on the level and type of additional efforts they make to cut emissions, which ensures that emissions are cut in the most efficient way and that innovation is incentivised. Thus, mitigating climate change risks.
- **Encourage Clean Energy Adoption:** in order to avoid paying carbon taxes, businesses will be incentivised to adopt clean energy options, thus reduce carbon emission and reduce their own costs. Wider adoption of renewable energy incentivise a wider investment in renewable energy options.
- **Fund Green Initiatives:** Revenues from carbon taxes provide a sizeable funding pool that governments can utilise for investments in clean technology R&D, mass public transit upgrades, sustainable infrastructure projects, environmental restoration efforts, and resilience funds for vulnerable groups.
- **Carbon taxes minimize the total cost to society of emission reductions:** Greenhouse gases are a classic negative externalities. They generate substantial costs that are borne by society at large, not just the person or organization responsible for the emissions. Carbon taxes cause emitters to internalize those costs. Those engaged in activities that can cheaply move away from using carbon will do so, and those that can't will pay the tax.

Question 4

Oil and gas projects are capital-intensive and involve significant risk due to their long-term nature and the high levels of sunk costs associated with exploration, development, and production. As such, investors seek assurances that the fiscal terms under which they invest will not be unilaterally changed by the host government, especially when commodity prices increase, making the project highly profitable. Fiscal stability clauses are a response to this concern, aiming to provide a stable and predictable fiscal environment, which is crucial for investor confidence. These clauses address the so-called "time inconsistency problem," where governments may have incentives to change fiscal rules after investments are sunk and the project becomes profitable.

Fiscal stability in this context refers to the assurance that the fiscal terms (such as tax rates, royalty regimes, and production-sharing agreements) governing an oil or gas project will remain unchanged for the duration of the project or for a specific period. The key issue is that once investments are made, they are sunk and non-recoverable, making it difficult for investors to withdraw from a project if the host government alters fiscal terms unfavourably. Without assurances of fiscal stability, this creates a risk that governments may increase tax rates or introduce new taxes after investments are committed, reducing the project's profitability.

The need for fiscal stability arises from the time inconsistency problem, where governments face conflicting incentives before and after investments are made. Initially, a government may offer favourable fiscal terms to attract investment, but once the project becomes profitable, it may be politically or economically expedient to increase taxes or royalties to capture a larger share of the rent from the project. This undermines investor confidence and can deter future investments.

There are two primary types of fiscal stability clauses used in oil and gas agreements. Under a frozen law clause, the fiscal terms in effect at the time the contract is signed are "frozen" for the duration of the contract or for a specific period. This means that any subsequent changes in tax laws, royalty rates, or other fiscal provisions will not apply to the project covered by the agreement. An agree-to-negotiate clause, on the other hand, provides more flexibility by requiring the parties to negotiate adjustments to the fiscal terms if changes in laws or economic conditions materially affect the economic equilibrium of the contract. These clauses allow for a rebalancing of the contract to ensure that both parties are restored to the position they would have been in had the changes not occurred.

For host governments, the inclusion of fiscal stability clauses can be a double-edged sword. On the one hand, these clauses can help attract foreign investment by providing legal certainty and reducing the perceived risk of investing in the country. This is particularly important for developing countries or those with a history of political or economic instability.

On the other hand, fiscal stability clauses can limit the government's ability to adjust fiscal terms to capture a larger share of the economic rent during periods of high commodity prices. If the government has agreed to a frozen law clause, it may find itself unable to benefit from windfall profits during a commodity boom.

For investors, fiscal stability clauses provide a critical layer of protection against the risk of arbitrary or unilateral changes to the fiscal terms of their investment. These clauses reduce the fiscal risk associated with long-term, capital-intensive projects and can improve the overall investment climate in resource-rich but politically unstable countries. Investors may prefer frozen law clauses because they offer complete certainty over fiscal terms. However, some investors may be willing to accept agree-to-negotiate clauses in exchange for more favourable terms in other areas of the contract.

The downside for investors is that fiscal stability clauses are not always inviolable. If a government deems the fiscal terms unsustainable, it may unilaterally change the terms. Moreover, frozen law clauses can lead to inefficient outcomes if the fiscal terms become overly favourable to the investor at the expense of the host country, creating potential for conflict and renegotiation.

Fiscal stability clauses are not a solution for the challenges faced by resource-rich countries. Overly generous stability clauses can lead to significant underpayment of government revenues when commodity prices rise. In contrast, hybrid models where fiscal stability is granted in exchange for higher tax rates or "insurance premiums allow governments to capture a greater share of the rent from resource projects while still offering investors some degree of fiscal stability.

Moreover, fiscal stability clauses are increasingly subject to renegotiation when the fiscal regime proves unsustainable or inequitable. As commodity prices fluctuate, governments may find it politically necessary to revise contracts, even if they include fiscal stability assurances. In such cases, international arbitration or negotiation is often the only recourse for investors. However, many companies are reluctant to invoke these clauses for fear of damaging long-term relationships with host governments.

PART C

Question 5

Part 1

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.

Part 2

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 advantage 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

Essential tax applying to the proposed investment, including rules for recovery of exploration expenses, treatment of capital expenditure, carry-forward losses, repatriation of profits, capital gains, transfer taxes, and indirect taxes such as VAT.

Hydrocarbon tax ring fence issues, such as restriction on interest deductions against ring fence income.

Determination of the holding structure, including election of a branch, single company or double company holding structure, consideration of taxation on income flows, withholding taxes, potential capital gains taxes on exit, and the funding structure of the investment.

The holding structure used if there are local or foreign partners.

Whether an intermediate holding country should be used for dividends, capital gains tax and related tax treaties.

Preparing a tax leakage calculation for the preferred structure, e.g. calculation from 100% of oil and gas income, reduction for taxes including any profit oil sharing under PSC regimes, calculating back to the net after tax cash to be received in the parent country.

Determining whether the seller is taxable in its own country of residence or the country where its assets are located and estimating the amount of tax.

Reviewing transfer taxes or stamp duty applying to the sale and related asset or share transfers, including the estimated amount, and whether these amounts are payable by the seller, the buyer, or are shared.

Determining any carry-forward tax losses under a tax and concession regime, or allowable costs under a PSC regime, in the transferred company or licence asset, and reviewing whether these amounts are preserved by the transfer, and whether there is any group relief, tax consolidation, or tax loss contribution available in the new holding structure.

Reviewing what related party and external funding requirements apply for the acquisition and anticipated future expenses.

Reviewing whether any interest payments on funds to acquire the company or asset is deductible under local country rules. Some countries limit deductions based on purpose of the loan, or if related party. Reviewing whether the debt and interest deductions have been pushed down to the profitable company.

Consideration of whether required loans are within this capitalisation rules in the borrowing country. These rules can generally disallow interest deductions on related party loans where a company's debt exceeds certain levels.

Reviewing whether there is an opportunity to increase the value of transferred assets to their market values to allow increased future depreciation deductions as an asset step up for tax purposes, for example by using an asset transfer rather than acquiring the company, or an asset transfer after the acquisition.

Consideration of any Goodwill in the transferred company, or asset such as a licence, and whether any tax relief available for the goodwill such as goodwill tax amortisation.

Consideration of transfer pricing issues in the new structure, particularly whether any intra group asset transfers or payments will be at arm's length prices.

Source: *Tolley's International Taxation of Upstream Oil and Gas*, 3rd edition. Content in the above solution has been reproduced from *Tolley's International Taxation of Upstream Oil and Gas*, 3rd edition, with the kind permission of RELX (UK) Ltd.

Question 7

In the oil and gas industry, leases are used to finance expensive equipment and vessels without the need for upfront capital.

Leases can be classified as either finance leases or operating leases, with a key difference being whether the lessee gains ownership of the asset at the end of the lease.

The tax treatment of a lease may differ from its accounting treatment, with tax qualifications depending on factors like ownership, lease term, and purchase options.

Lease accounting follows International Accounting Standard 17 (IAS 17), which provides guidance on classification.

A Finance lease is treated as debt on the company's balance sheet, with tax deductions for the interest portion of lease payments and depreciation of the asset.

An Operating lease is treated as a rental transaction, allowing full deduction of lease payments for both tax and accounting purposes, without adding debt to the balance sheet.

Operating leases typically offer more tax benefits as the full rental payments are deductible, leading to faster cost recovery.

Operating leases avoid the recognition of debt, which can be seen as a financial strength, especially for attracting investors.

Oil and gas companies often engage in cross-border leasing, making it crucial to consider withholding taxes, VAT, and Double Tax Treaties (DTT).

Attention is needed to determine whether lease payments are classified as royalties or interest, which affects withholding tax rates.

Lease transactions must consider VAT, potential exemptions, stamp taxes on documentation, and customs fees for imported equipment.

In sale-leaseback arrangements, an oil and gas company sells an asset and leases it back, often qualifying as an operating lease, allowing access to funds without losing the asset.

Sale-leasebacks provide tax efficiency through the full deductibility of rental payments, which may be higher than depreciation deductions if the asset is fully depreciated.

It's important to analyse the tax consequences of the initial sale, including potential capital gains, to ensure the transaction is tax-optimized, especially when tax losses can be used.

Sale-leasebacks between related parties often involve setting up a leasing company in a tax-efficient jurisdiction. However, anti-abuse rules require the leasing company to have economic substance, including staff, directors, and capital.

Question 8

Royalties ensure that governments receive early, revenue from extractive industries based on license awarded and production rather than profitability, providing stable income streams.

Royalties, especially ad valorem (value-based), are simpler to administer than profit-based taxes because they rely on production data or commodity prices.

Since royalties are based on production, they provide a consistent revenue source for governments, even if extractive companies report losses.

Royalties help governments mitigate risks related to price volatility and operational challenges in extractive industries by ensuring revenue even in low-profit periods.

A major drawback is that royalties are regressive, not reflecting a company's profitability, which can discourage investment, particularly in marginal or high-cost projects.

Royalties do not efficiently capture the economic rent (excess profit), especially during commodity price booms, when companies generate substantial profits.

Profit-based taxes like Resource Rent Tax (RRT) and corporate income tax (CIT) are more efficient in capturing economic rent, as they adjust with profitability.

Profit-based taxes do not distort investment decisions, making them more favourable for companies investing in high-risk or low-margin projects.

Profit-based taxes require sophisticated administration, including auditing, cost verification, and addressing issues like profit-shifting and transfer pricing, posing challenges for developing countries.

A balanced approach combining royalties with profit-based taxes can stabilise government revenues, capture economic rent efficiently, and mitigate risks, as seen in countries like Australia and Norway.