

Answer-to-Question-_1_

1) Difference between concession agreements and PSA

Concession agreements:

In the concession type of agreement, Lucky oil PLC will be granted a license for extraction of hydrocarbons. In exchange the government of ABC will receive bonus and rentals for the use of land. In effect the government gives up the right for share in the production of Hydrocarbons to the IOC ie Lucky oil. The cost, risk and right to operate is in the hands of Lucky oil

Production sharing agreement (PSA):

In PSA, the agreement is entered between Lucky oil and the government of ABC, whereby the nation will own the resources and give the right to extract hydrocarbons will be given to Lucky oil. The government will get maximum revenue here in the form of royalty, signature bonus, rentals and share of the profit (profit oil), taxes. Lucky oil will consume all risk in relation to exploration but the resources will be owned by the government. The IOC can recover its initial expenditure incurred for the exploration in form of cost oil. However there will be a cap on the expense to be recovered. The government will maintain decision on how exploration and development of hydrocarbons has to be undertaken. The Government will try to take the maximum share

The key features between concession agreement and PSA are

- In concession agreement, the main revenue for government will be bonus and rentals. sometimes royalty is also possible depending on the terms of the agreement. Further the government will give up its share of production.

- In PSA, the government will have a strict control and will not provide free access to IOC to extract the resources. They will try to get the maximum revenue from the project as they own the land and the resources in it. Revenue earned by Government as highlighted above include, Bonus, rentals, royalty, profit oil and taxes paid by IOC.

2) For the below numerical, in case of concession agreement entire profit will go to Lucky oil.

In PSA, government will get a share of production in nature of profit oil. It is assumed that government of ABC share is 60%

Year 1

Exploration cost - \$5,000,000
Development cost - \$2,000,000
Total Cost - \$7,000,000
Royalty - NIL (Since no sales made)
Tax paid - NIL (Loss due to no revenue and only loss)
Cost carried forward - \$7,000,000

Year 2

Total Sales - \$ 135,000,000
Royalty - \$13,500,000
Total cost - \$7,000,000

Profit oil - \$ 135,000,000 - \$13,500,000 - \$7,000,000 - \$7,000,000 (cost carried from Year 1) = \$107,500,000

Profit allocated to Government - \$64,500,000
Profit allocated to Lucky oil - \$43,000,000
Corporate tax paid by Lucky oil (in case of PSA) - \$8,600,000
Corporate tax paid by Lucky oil (in case of concession) - \$21,500,000

Year 3

Sales - \$200,000,000
Total cost - \$2,000,000
Royalty - \$20,000,000
Profit oil - \$ 178,000,000
Profit allocated to Government - \$106,800,000
Profit allocated to Lucky oil - \$71,200,000
Corporate tax paid by Lucky oil (in case of PSA) - \$14,240,000
Corporate tax paid by Lucky oil (in case of concession) - \$35,600,000

Year 4

Sales - \$300,000,000

Total cost - \$2,000,000

Royalty - \$30,000,000

Profit oil - \$ 268,000,000

Profit allocated to Government - \$160,800,000

Profit allocated to Lucky oil - \$107,200,000

Corporate tax paid by Lucky oil (in case of PSA) - \$21,440,000

Corporate tax paid by Lucky oil (in case of concession) - \$53,600,000

Year 5

Sales - \$480,000,000

Total cost - \$2,000,000

Royalty - \$48,000,000

Profit oil - \$ 430,000,000

Profit allocated to Government - \$258,000,000

Profit allocated to Lucky oil - \$172,000,000

Corporate tax paid by Lucky oil (in case of PSA) - \$34,400,000

Corporate tax paid by Lucky oil (in case of concession) - \$86,000,000

Based on the above workings, in concession regime the total revenue for ABC government will be

Corporate tax earned for all the 5 years which is \$ 196,700,000

The total revenue earned by ABC government will be the royalty, corporate tax and the profit oil

Total Royalty for 5 years = \$ 111,600,000

Total tax paid by Lucky oil = \$ 78,680,000

Total profit oil for 5 years (ABC government share) = \$ 590,100,000

Total revenue will be \$780,380,000

In this PSA agreement will be beneficial as it provides more revenue to ABC government

3) In case if there is a boom in the oil and gas market, the government

will try to charge windfall tax from the company.

In case if a ring fencing provision is applied in country ABC, ring fencing tax might also be charged from Lucky PLC

Further if Lucky PLC pays any intra group charges, dividend or interest to its related parties, withholding tax can be charged on the same

Answer-to-Question- 2

1) **Introduction:**

Every country wants to tax income based on the source rule and wants its share of tax. However due to various tax structuring done by the MNE, the source government will lose its share of revenue.

Further every holding company will want to maintain a minimum profit in the source and repatriate back the balance to its jurisdiction.

Transfer pricing:

The simple concept of transfer pricing states that, any transaction undertaken by a company with its related party should be at Arms length price, i.e. price at which two independent parties transact in the market. This helps to achieve a balance between the interest of tax payers and tax administrators in a way which is fair to all parties.

When two related parties transact with each other, there is a possibility that prices will be influenced. Basis this the country where there is high taxation rate will have low profit in terms of higher expenditure or lower revenue and country which are low tax jurisdiction will face the vice versa.

Further the tax authorities should also consider whether the transaction entered between related parties are of substance and it should be in line with the function and value aspect of the group

2) **Methods of Transfer pricing**

- Comparable uncontrolled price method:

In CUP, it compared the price charged for the property or services transferred in a controlled transaction to the price charged for property or service transferred in a comparable uncontrolled transaction in comparable circumstances. This has both internal CUP and external CUP

In oil and gas operations, if a royalty is paid for drilling services by an company undertaking operations, external CUP method can be used to benchmark this transaction where similar royalty paid by third parties will be considered

- Resale price method:

This is generally applicable to distributors where the method begins with the price at which a product has been purchased from an associated enterprise is resold to an independent enterprise. This price is then reduced by an appropriate gross margin which covers the amount which the reseller would seek to cover its selling and distribution cost. Applicable to those distributors who do not do much value addition

In oil and gas operations, Oil and trading company can use this method, where oil is purchased from group operation companies and sold to third party customers

- Cost plus method:

This method begins with the cost incurred by the supplier of property or services in a controlled transaction for property or services transferred to its related party. An appropriate markup is then added to the cost in light of functions performed and market condition.

This method is generally used for semi finished goods are transferred or services provided between group entitites

- Transactional Profit split method:

This method is applicable when there are intangibles involved and each

party makes a unique and valuable contributions. The method first identifies the profit to be split from the controlled transaction and splits between the associated enterprise on an economically valid basis. This method will be useful when compensation to the associated enterprises are made based on the relative contribution made to the profits.

- Transactional net margin method (TNMM)

This method examines the net profit relative to an appropriate base that a taxpayer realises from a controlled transaction or aggregated transactions.

The base can be in form of operating cost, operating revenue, net assets depending on the scenario. There are two types of TNMM internal TNMM and external TNMM.

3)Challenging of transfer pricing methods by tax authorities:

- Where a royalty is paid by an operations company to the IP holding company using an external CUP, the tax authorities can argue on the comparable agreements taken by the operations company and they can scrutinise the nature of services. Sometimes the exact applicable to applicable comparable agreement cannot be identified and this requires adjustment. Where no adjustment is made, the tax authorities can scrutinise and reject the agreement.

- In case of a distributor where resale price method is applied for trading of goods by a trader, if transfer pricing authorities determine that the trader does more function than routine distribution and incurs significant value addition and marketing expense, it can reject the RPM applied by the trader and consider TNMM as the most appropriate method for benchmarking the transaction. Here the trader will have to substantiate the functions undertaken by the trader

- Generally the tax authorities tend to consider intra group charges paid to parent or holding company as method for base erosion. They can consider the entire transaction as sham and determine the arm's length price at NIL. In India, there are judicial precedents which highlight that tax authorities cannot determine the arm's length price as NIL and

one of the transfer pricing methods to be considered for determining the arms length price.

If an IOC has yearly litigation on the transfer pricing methods, the IOC can negotiate with the tax authorities by undertaking an APA which will help the IOC to avoid litigation cost and tax authorities can get the rightfull tax post the negotiation and the tax authorities need not implement more resources for the litigation

Answer-to-Question- 3

1) **Introduction:**

When a company undertakes oil and gas exploration, it tends to emit greenhouse gases which tend to damage the environment. To tackle this, countries have introduced carbon pricing. Carbon pricing refers to the mechanism used to reduce carbon emissions whereby a cost is imposed to the business entities and individuals undertaking activities which lead to emission of green house gases.

The IOC has to maximise revenue from exploration activity but also has to keep sustainability in mind when undertaking the exploration activity.

Carbon tax:

It is a fee imposed on business and individual that burn carbon fuels and emit green house gases. Mostly these are seen in upstream stage where burning of oil happens which leads to carbon emissions:

Advantage of carbon tax:

- Since this a cost to the IOC, many companies will try to substitute to cleaner and green energy
- Carbon taxes collected by the government can be used to research and development of green energy. The carbon tax are easy to implement by the government.

- As it is a cost which involves outflow of cash, IOC will try to reduce the emission and try to keep at the minimum. Further this will try to reduce the adverse impact of green house gases emission
- Many companies have to report in its Board report on the energy conservation activities undertaken which will be presented to shareholders
- Further many fundings are also dependent on the achievement of climate related results. This will be monitored from time to time and once the results are achieved only then the company will get the funding for business purpose.

2) **Emission trading**

Emission trading allows IOC to trade emission allowances in the market which will lead to an income.

There are two types of schemes:

- Cap and trade:

In this the government establishes a limit on emissions for a particular period and allowance that make up the cap are either auctioned or allocated.

- Base line and credit

In this there is no fixed limit on emissions. A limit is placed on routine carbon emitters. If they are below the limit they will receive credits and if they exceed the limit they will have to purchase the credit.

The emission trading schemes have helped many companies engaged in oil and exploration to reduce the carbon emissions as the lower the limit they will receive credits. Higher the emission post the base limit, they will have to purchase the credit which leads to cash outflow.

1) **Introduction:**

An IOC can have growth via 2 ways: one either by organic growth or the other via mergers and acquisitions. If undertaking by mergers and acquisitions, it can be either by purchasing of assets or by purchasing shares.

When undertaking a mergers and acquisitions, the company should have funds to undertake this. The funds can be in the way of debt or equity. Using more of debt or more of equity has its own problems. A mix of both should be considered.

Regime aspects:

Where a debt is used to finance the mergers and acquisition, interest will be paid which will lead to reducing the taxable profits. However in case of production sharing agreement, interest cannot be recovered via cost oil.

Thin capitalisation rules:

In case a loan is borrowed from related party or third party, the interest payment can lead to reduction of profit. Further there can be situations where base erosion can take place via

- Groups placing higher levels of third party debt in high tax countries
- Groups using intra group loans to generate interest deduction in excess of the groups actual third party interest expense
- Groups using third party or intra group financing to fund the generation of tax exempt income

To avoid the above implications, BEPS Action Plan 4 was introduced to recommend best practices

One of the recommended approach will to use a fixed ratio rule which limits an entity's net deductions for interest and payments equivalent to interest to a percentage of EBITDA (earnings before interest, taxes,

depreciation and amortisation). Ratio can be from 10%-30%. Another approach is a group ratio rule.

Tax implications on interest deduction - Purchase of assets:

In this the IOC purchases the valuable assets of the target company. Where loan is borrowed to finance the acquisition, interest will be paid which will reduce the taxable income. However interest will be allowed here as deductible expense since it is used to purchase assets which will provide economic value and used in business to generate assets. Where a loan is borrowed from related party, transfer pricing aspects also to be considered to make sure that the interest paid is at arms length price. Further to make sure the interest paid does not attract the thin capitalisation rules as highlighted above. Treaties to be considered for reduction in withholding tax paid on the interest.

Tax implications on interest deduction - Purchase of shares:

In this, the IOC purchases the shares of the company making it a holding and subsidiary relation. Where a loan is borrowed, interest payment will be a challenge here as it is used to acquire an asset (shares) which earns an exempt income (dividend) via a participation exemption.

Tax consolidation rules in the country to be looked into which consolidates the tax return. In this case the profits earned by the target company and the interest paid by the holding company will offset company in target company location.

2) Debt pushdown

This is a tax structuring where a special purpose vehicle is created in the target company location. A third party loan will be borrowed for financing the acquisition. Once acquired, the target company will merge with the SPV or the loan will be transferred to the target company. The target company will have good profits which can be used to offset the interest expense.

The tax implications include to understand for what purpose the SPV has been structured and this will involve the anti abuse rules which can reject the SPV company as it does not have any substance which can lead

to rejection of the transaction.

Further, the timing of interest paid also to be checked as it might acquire company which is in the initial stages of oil exploration and will have losses which cannot be used to offset the interest expense.

Answer-to-Question- 8

PE is defined in Article 5 of the OECD model convention and the domestic laws of the country where the contractor is located.

The term PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes place of management, branch, office, factory, workshop and a mine, **oil or gas well**, a quarry or any other place of extraction of natural resources.

3 conditions to be met to determine the existence of a PE:

- Existence a place of business
- The place of business must be fixed
- Carrying on of the business of the enterprise through the fixed place of business.

Where a PE exists, the business profits of the PE will be taxed in the host country as per Article 7.

In case of a dependent agent PE, where the agent habitually concludes contract on behalf of the principal then it can be said that a PE exists. Further Para 4 determines that if the entities are engaged in auxiliary activities, it would not lead to PE.

Further Service PE can also be established where employees visit the host country and stay for more than a certain number of days

Generally when an oil and gas company start their activities, the start

out as a representation office in the host country where they will understand the market and develop its establishment. Their role will be that of a mere liaising activities to the head office which are in the nature of auxiliary activities and they won't conclude contracts. If they conclude contracts on behalf of the head office, there exists a PE

BEPS Action Plan 7 also highlights that in case the head office fragments a cohesive operating business into smaller operations, the anti fragmentation rules will apply.

Let's take an example of a Finnish company having a branch in India for oil and exploration activity. The India and US treaty can be considered:

When the branch registers in India for foreign exchange regulation purpose, it will attract PE. Further India and US treaty defines a PE to include branch

The branch does not have its own identity but will be considered as an extension of the head office. Since the branch enters into contract with customers, it can be said to have a permanent establishment.

Article 7 states highlights that the profits of an enterprise of a contracting state shall be taxable only in that state **unless the enterprise carries on business in the other contracting state through a permanent establishment.**

As there exists a PE, the profits earned through the PE will be taxed in India at the rate of 35% (foreign company taxation). However credit on tax paid in India can be obtained by the Finnish company (head office) when calculating the overall tax of head office.

Further in India, transactions between a branch and Head office can be in the ambit of transfer pricing regulation. Hence the Finnish branch will be treated as separate and independent entity

Further Article 10 and Article 11 also highlights that in case a dividend or interest is paid in connection to a permanent establishment, such dividends or interest will be taxed in the location of the permanent establishment.