Answer-to-Question-_1_Part A

Petroleum agreements take various forms depending on the jurisdiction in which the IOC intends to invest in. These are agreements are mostly structured in a manner that ensures the host government maximises the wealth it can yield from its minerals resources based on sustainable development goals for that state. In the same manner IOCs try to ensure that the agreements are structured in a manner that maximises shareholder wealth through maximum profits but with the least cost possible. The three types are discussed below.

Concession Regime

-Under a concession regime goverment transfers ownership and title to the IOC for a defined area or location.
-the host government grants an operating license to the IOC or a lease for a defined period of time
-host goverment exercises very limited oversight role udner this agreement
-tax is paid in various forms i.e. in the form of royalties, discovery bonuses, signature bonuses just for being awarded the contract production bonuses when the IOC starts production and fixed annual rentals or payments amongst other forms of payments.
- taxes can also take specific forms i.e. Special Petroleum Tax which can be in addition to the standard corporate taxes
-tax can also be paid in a ring fenced manner i.e. Ring Fence Corporation Tax in some states

Production Sharing Agreements

-this is a contractual relationship between the host government and the IOC similar to a Concession regime.
-government retains ownership and title of the Oil resources in the ground.
-unlike a Concession regime host government only gives IOC title to their share of produced hydrocarbons and not the whole site.
-government gets its taxes in the form of royalties as similar to

a concession agreement, they also get profit oil from their share of the profits.
-government also gets income tax from the IOC's portion (investor share) of the profit oil
-IOC gets cost oil in full which is a recovery of the costs they incurred in exploration and production.
-in the initial stages some costs cannot be recovered under cost oil i.e. exploration expenses or finance costs such as interest deductions.
- the IOC as the investor gets their share of profits net of income tax paid to host government.
-can take two forms i.e. ordinary PSC were IOC pays all taxes or a Tax Paid PSC where the host government pays tax on behalf of the IOC from their share of the profit oil.

Service Contracts

-unlike the PSC agreement which creates a partnership agreement with the host state, the Service contract creates an employer - contractor relationship between the host state and the IOC.
-unlike the Concession Agreement which transfers title, the service contract does not transfer title to the IOC.
-for perfoming the required services the IOC get remunerated either in cash or with an option to purchase a portion of discovered oil based on the pre-agreed parameters e.g a discounted rate.
-unlike the PSC and concession agremeent, the service contract is considered the most stringent of agreements as the host government seeks to exercise the highest level of control over the hydrocarbons.
-service contracts can take two forms ie. pure service contract (which are rare to find)or risk service contracts which are more common.
-under the pure service contractor the investor is paid despite making an oil and gas discovery or engaging in successful production of the hydrocarbons.

-the risk service contract is similar to the PSC arrangement as the contractor only benefits or gets paid if they are able to successfully put the project into commercial status.
-tax payable by the IOC is based only on their income that they have received from the host government for service provision.
-unlike the PSC and concension regimes there are no royalty payments or production bonuses to be paid.
-most service contracts specify the extent to which costs can be recovered.

Answer-to-Question-___2 Part A

How goverments change tax regimes and impact on IOC returns

-governments can exercise their sovereign power and nationalise assets of the IOC such that the later cannot export back their equipment after decomissioning hence suffer major capital losses as they have to secure new equipment for new projects.

-change the tax regime i.e. introduce additional taxes after the licenses have been granted which further limit the profits of the IOC i.e. introduce additional profits tax on foreign companies operation in their jurisdiction. The government can even change the capital allowance rules such that the IOC can no longer claim back their capital expenditure for the project which may results in greater amounts of tax being paid.

-introduce new tax regimes that encourage investment from new entrants but prejudice the profits of the existing IOCs i.e. tax sparing and tax incentives which create an uneven playing field which affects pricing of the oil and gas products which can ultimately affect the expected return on the investment as the expected revenues are diminished.

-amend exchange control regulations such that profit expatriation is delayed and highly controlled as changes to the foreign exchange regulations would make taking out the profits difficult. This can be done in the form of currency controls on the amount of foreign currency that the IOC can take out in a defined period of time.This can also impact on the IOC cashflows especially where they are part of an MNE group with intra group borrowings such that their ability to repay debts is limited affecting their credit worthiness.

Solutions on how IOC protect their investments

-tax Paid PSC

The IOC can opt for a tax paid PSC to ensure that what changes the host government makes to the tax regime, the IOC will not be affected since the government pays the IOC tax from the profit oil. Such an arrangement provides assurance that future changes will not distort their net profits as the changes would only affect the government's share of the allocation of the profit oil.

-Use of tax stabilisation clauses

-commitment clause ensures the host state does not have the leeway to nationalise the IOC assets.
-guarantee clause ensures that claims for capital allowances are predertemined and cannot be altered at a future point hence prejudicing the IOC.
-currency clause is used as a way of locking the currency for payment of taxes for assessments and returns such that the host government cannot change it without notice or agreement with the IOC
-freezing clause is important as it ensures that the existing domestic law will remain in force for the entirety of the agreement and any new or additional changes to law are specifically excluded from becoming enforceable.

As noted above most of the stabilisation clauses are more on the economic aspects so that the IOC is protected on its investments when carrying out a project under the various petroleum structures. However, there are challenges in the legal enforceabilty of some of the stabilisation clauses which some host governments can wantonly challenge hence IOCs can resort to Arbitration mechanisms.

-Arbitration

This is an alternative form of dispute resolution that both the host state and the IOC can resort to should they be unable to amicably reach a consensus. The port of call can be approaching national courts of the host state which may however tend to be biased. The next option may be to utilise the provisions of the **Bilateral Investment Treaties (BITs)**if these are applicable between the host state and the IOC state of residence. For example an IOC in the EU can use the EU Investment treaties which provide uniformity and protection against appropriation without compensation.

IOCs and host state can also revert to the **The Energy Charter** which is a multilateral treaty if the concerned states are signatories to the charter. The Charter will provide protection for foreign investors and ensures non-discriminatory treatment of IOCs and adherence to trade rules as guided by WTO.

Answer-to-Question-___4 Part B

PE concept

-Article 5(1) of the OECD MTC defines a PE as a fixed place of business through which a business enterprise is carried out. This may consist of a branch, an office, construction site, worshop, mine, oil and gas well or a quarry site or any other place of extraction for mineral resources.

PE's can take various forms depending on the type of set up i.e there can be a **physical presence PE** which consists of a fixed place of business from which the business activities are carried. However mere existence of a site does not warrant its recognition as a PE unless that site site is at the disposal of the entity. A drilling rig which is semi-fixed can also take the form of PE despite it being moved from different sites.

Another PE form is that of a **construction site** which is in place for a period of 12months or 6months depending on the OECD and UN provisions respectively. Considerations are made by both the IOCs and tax authorities were related parties can split projects into smaller periods to avoid the 12mth rule. However a site created for the mere purpose of display, storage and delivery of goods would not constitute a PE as well as any services that are of a preparatory or auxillary nature as these are considered inadequate to create a PE status.

An **agency PE** is another form to consider, this can be created where an agent is considered to be a dependant agent. This type of agent would habitually conclude contracts on behalf of the enterprise without any material changes. To avoid the PE status enterprises can make use of independent agents or commissionaires who can make decisions in the ordinary course of doing their

business.

Tax considerations for service companies

IOC's can also make use of Representative offices to avoid having a PE, this office would not make any direct sales nor conclude contracts on behalf of the Head Office and to cement the position any contracts entered into with the representative office should not be considered binding unless endorsed by the head office.

IOC's should consider wether to lease FPSO vessels i.e leasing drilling ships as bare charter boats in offshore locations so that no PE is created. Under the lease arrangement the lessor may be the one with the PE status and not the IOC as they will be leasing only without control.

Service companies can also be in the form of
Seismic surveys and Earth scanning companies which need to make tax considerations regarding export and import controls i.e. export and import duties on bringing in equipment and taking it out. They need to consider other related tax issues such as import VAT, and classification of goods for VAT purposes. These service companies can either create a PE or be used to avoid one ie,training and Technical Inspection services teams may come in for short periods of time. Considerations should be made however for WHT issues for technical fees or royaties based on wether there are Double Tax Treaties in place.

There can be a service PE in cases where the agent is actually involved in the arranging of contracts for the provision of the services by the non resident company for instance in a case where an employee provides services in a state for period exceeding 183days in a given 12month period and a significant portion of their activities contribute to the gross income of the enterprise.

IOC's can avoid having service PE's in a host state by making use

of a seperate or different company i.e an SPV that actually provides the local company services which has to be separate from the drilling company. The tax authorities will check wether the SPV has an economic and or commercial substance otherwise they can invoke non-recognition provisions. For the SPV or local company to have substance it needs to have the adequate staffing levels with the properly qualified staff to make the significant technical, risk and management decisions.

Answer-to-Question-__6 Part C

(1) Tax Implications related to decomissioning costs

Decomissioning is the process by which an IOC or an investor winds up operations in a host state through the removal of installations rehabilitating abandonment wells amongst other processes.

The challenge is that on decommissioning entities incur various decomissioning expenses and usually these are incurred at the point at which the oil well is barely making a profit if at all and production has dwindled so much. In this instance the proceeds that the entity gets from the sale of the oil proceeds are inadequate to cover the huge decomissioning expenses such that the entity is left with unrelieved tax losses without the provision of a tax benefit because they could not pre-recognise the expenses whilst they had not been incurred especially in the phases when the oil well was still making profits.

Most tax legislations do not allow for claiming of expenses prior to them being actually incurred and this is a disincentive to many IOC given that the exit process of decomissioning the assets requires large cash flows and carry significant expense amounts.

Other tax implications may be the exit taxes that some governments charge upon winding up of operations in their state. These may include capital gains tax on the assets that may be deemed to have been sold depending on the legislative provisions of that jurisdiction. As such IOC's should make tax provisioning for such taxes to prepare themselves in the event of winding up operations.

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IOC's should consider investing in states which allow for a refund of such costs i.e. Norway or states which allow for a carry-back of decomissioning costs against prior profits for tax purposes so as to minimise the risk of unrelieved losses.

Considerations should also be made to invest in states with Approved Abandonment Programs like the UK where a decomissioning cost which is incurred within the provisions of the program is allowed as a deduction for tax purposes under Decomissioning Allowances.

Answer-to-Question-__6 Part C

(2) Tax Implications of operating and finance leases

Leases take up different forms which can be an operating or finance lease depending on its characteristics. With an operating lease, lessee does not obtain ownership of the assets and vice versa with a finance lease.

Operating Lease

-Since ownership is not transferred, this is considered a mere rental such that payment for the lease i.e. lease rental is an allowable deduction for tax purposes.

-The interest component of the lease is allowed as a deduction as this was in relation to a debt that was incurred as part of raising funds to generate trading income or revenue.

Finance Lease

The lessor charges the lesee rentals which cover the Capital cost of the asset in addition to the interest on the funds borrowed to purchase the asset.

-The lessee may depending on the jurisdiction claim capital allowances for the lease amount since is considered as having incurred capital expenditure.

-Leasing through a finance lease can create PE implications in some scenarios for the lessor company i.e. where an FPSO vessel is considered to create a PE where the lessor has the significant decision making and control over the leased equipment.

-In some jurisdictions there may be WHT implications on the lease payments if they are cross-border payments. These WHT implications may be addressed through Double Tax Treaties which may provide relief on any applicable WHTs.

-In some states there may be VAT issues if the lease is considered to be a supply of goods or services which should be subjected to VAT. In some cases, finance leases may be exempted were they may be categorised under finacial services hence they will not be liable to VAT.

Answer-to-Question-___7 Part C

Ways in which Thin Cap rules affect deduction of interest expenses

-Debt to Equity rules in some states limit deductibility of interest to certain ratios i.e. an interest in excess of 3:1 is disallowed for tax purposes and is recognised as a deemed distribution/dividend which attracts a WHT charge. In such jurisdictions there cannot be interest deduction optimisation as it will result in additional tax expenses in the form of WHT.

-Many IOC companies acquire debt funding to commense operations in host states through the purchase of assets to be used in the host state. Most of these debts attract interest expense which may however not be recognised in the host state especially under PSC where financing costs inclusive of interest are not allowed as deductions in dertemining cost or profit oil. In such instances the thin cap rules would apply as they limit the deductibility of any portion of the interest in the inital stages.

-In one state the purchaser of assets can claim a deduction in their host country but they may fail to properly utilise if they do not have adequate income to support the deduction.

Options available
-Debt push down structures
This has the objective of utilising the interest deduction in the target company to offset its profits. This is done by using 3rd party borrowings within the MNE group which may work in some jurisdictions where 3rd party debt from local banks or unrelated parties is not considered within the thin capitalisation realms.

So incurring the debt from the 3rd party and including it in the group would then provide a way of going around the thin cap restrictions.

-**Tax consolidations** may be used to push down the debt through the creation of an SPV which acquires the target company assets on behalf of the acquiring company. In this instance the SPV is part of a tax consolidation and its interest deductions would then be used to reduce the tax in the target company. In the same way the thin cap issues would not apply as these would have been diluted within the group as part of the consolidation.

-**Timing of including or adding debt** to the structure is key. To avoid violating thin cap rules in the inital phases, then related party debt should be included in later phases when the IOC company is now profitable such that the deductions can then be utilised. in this way in the early stages where there is already high gearing due to initial investment requirements, thin cap rules are adhered to as the gearing ratios are not increased through increased debt.