

# **THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION**

June 2023

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## **MODULE 3.04 – ENERGY RESOURCES OPTION**

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### **SUGGESTED SOLUTIONS**

## **PART A**

### Question 1

Candidates are expected to discuss PSA in terms of length, tax components, and possibly refer to countries that use this type of agreements.

They are expected to highlight the key tax differences between PSA, Concession contracts, and service contracts.

### Question 2

The key factors that determine the tax liability of O&G Inc. in each of the countries it operates in are, amongst others:

- The tax laws of the country, including the tax rates and the rules for determining taxable income.
- The type of operations conducted by O&G Inc. in each country, such as exploration, production, or refining.
- The structure of the operations, including whether the company operates through subsidiaries, joint ventures, or partnerships.
- The allocation of income and expenses among the different entities within the company's structure.
- The availability of tax incentives, such as deductions, credits, or exemptions, in each country.

O&G Inc. manages its tax liability in the countries where it operates by, amongst others:

- Conducting tax planning to maximise deductions and credits and minimise taxable income.
- Structuring its operations to take advantage of tax incentives.
- Maintaining compliance with the tax laws of each country.
- Monitoring changes in tax laws and regulations and adjusting its operations accordingly.
- Negotiating with tax authorities to resolve disputes or reduce tax liabilities.

O&G Inc. can minimise its tax liability while remaining compliant with the tax laws of each country it operates in by, for example:

- Taking advantage of tax incentives, such as deductions, credits, or exemptions.
- Structuring its operations to reduce taxable income and increase deductible expenses.
- Using transfer pricing to allocate income and expenses among the different entities within the company's structure in a way that minimises tax liability.
- Utilizing tax treaties between countries to avoid double taxation.
- Conducting tax planning to identify tax-efficient strategies.

Tax treaties between countries impact the tax liability of O&G Inc. in each country it operates as, for example:

- Eliminating or reducing double taxation by allocating taxing rights between countries.
- Providing for reduced withholding tax rates on certain types of income, such as dividends, interest, and royalties.
- Establishing procedures for resolving disputes between tax authorities.
- Providing for mutual assistance between tax authorities in the enforcement of tax laws.

Some of the challenges that O&G Inc. may face in managing its international tax liabilities may include:

- Complying with the tax laws of multiple countries with different tax systems and rules.

- Dealing with the complexity of transfer pricing rules and regulations.
- Managing the tax implications of mergers and acquisitions in different countries.
- Addressing the risk of tax audits and disputes with tax authorities.
- Balancing tax efficiency with ethical considerations and public perception.
- To overcome these challenges, O&G Inc. can hire tax professionals with expertise in international tax and transfer pricing or implement a comprehensive tax compliance program. It could also maintain open communication with tax authorities and seek to resolve disputes through negotiation.

## **PART B**

### Question 3

Candidates are expected to discuss the mechanism of ETS and carbon pricing. They may discuss their impacts on reducing emissions. They may also refer to the EU and/or the UK ETS, or any other country's ETS.

In discussing carbon pricing, candidates may demonstrate awareness of the World Bank article on this topic.

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

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

### Question 4

Transferring an oil and gas license from one party to another can have significant tax impacts in the international tax context. Depending on the type of transfer and the tax laws of the countries involved, the transferor and the transferee may face different tax considerations and potential tax liabilities.

The tax impact of the operation, as a general rule through the taxation of any capital gains, may be significantly impacted by specific issues which stand outside the applicable tax scope. For example, the market value of the license itself may be lower than the price being paid by the third party entering the license (e.g. where a commercial discovery has not yet been made).

One other aspect is the specific agreement made between the Government and the current holder of the license which may foresee a special regime for the tax treatment of capital gains outside the treatment of capital gains according to the domestic tax legislation.

The taxation of a transfer or a license can be achieved through different taxes depending on the jurisdiction (e.g. capital gains tax, corporate income tax, stamp duty tax, value-added taxation, etc) and can also be impacted by the double tax treaties entered into between the country where the license is held and the country where the license owner is a resident.

Asset transfers, share transfers, and farm-ins are three common types of transfers in the oil and gas industry, and each may have different tax implications.

In an asset transfer, the transferor sells specific assets related to the license, such as production facilities or pipelines, to the transferee. In a share transfer, the transferor sells shares in the company holding the license to the transferee. In a farm-in, the transferee acquires an interest in the license and agrees to fund a portion of the costs associated with the license.

For the transferor, tax considerations may include:

- **Capital gains tax:** The transferor may be subject to capital gains tax on the sale of the assets or shares related to the license. There can be impacts of the depreciation of past costs and signature bonus paid where a deduction is not given for past costs spent with the license when assessing the capital gain.
- **Transfer pricing:** The transferor may need to consider transfer pricing rules if the transfer involves related parties, to ensure that the transfer is conducted at arm's length.

- Tax residency: The transferor's tax residency may impact the tax treatment of the transfer and potential withholding tax obligations.

For the transferee, tax considerations may include:

- Withholding tax: The transferee may be subject to withholding tax on the purchase price paid to the transferor, depending on the tax laws of the countries involved.
- Depletion allowances: The transferee may be entitled to depletion allowances, which are deductions for the reduction in the value of the oil and gas reserves over time.
- Tax residency: The transferee's tax residency may impact the tax treatment of the transfer and potential withholding tax obligations.

Tax planning initiatives may be used to manage the tax impacts of transferring an oil and gas license. These may include structuring the transfer as an asset transfer, share transfer, or farm-in, depending on the tax implications of each type of transfer.

You can also choose the location of the transfer to optimise the tax outcome, taking into account the tax laws of the countries involved.

One other consideration is the use of tax treaties to reduce or eliminate potential withholding tax obligations.

Tax impacts of transferring an oil and gas license may also be managed through a variety of other strategies. For example, the use of special purpose vehicles (SPVs) may be used to transfer ownership of the license, and the transfer pricing methodology may be used to allocate profits and expenses between related parties involved in the transfer.

In direct or indirect transfers, the parties should always consider tax impacts related to unrelieved losses or capital allowances. Limitations may exist in the utilization of these losses by the acquirer of the license and to the interest deductions structures.

Possible ways to structure the transaction and optimise the tax impact of the transfer may be to agree to a cost carry type of deal. This is common in farm-down agreements where the current holder is only transferring part of the currently held license to a third party.

In a cost carry deal, there is a transfer of part of the license for a non-cash consideration. The Farminee agrees to carry the Farminor up through the rest of the exploration phase of the license. This means that the Farminee will pay a higher share of the costs that the ownership share it is acquiring or in other instances it agrees to pay future royalties liabilities.

These types of deals are harder tax because the tax laws do not foresee the taxation of a transaction without any consideration paid in cash. Possible application of anti-avoidance provisions or transfer pricing rules may nonetheless attribute a cash value to the deal and subject that amount to tax under capital gains tax or corporate income tax.

The risk is higher in a situation where caps for costs or royalties to carry are established in the farm down agreements which makes it easier to determine the market value of the deal.

Another possible solution would be to make use of a double tax treaty to exempt capital gains taxable under the domestic tax legislation as some agreement expressly exempt non-resident capital gains obtained on the sale on movable property.

## **PART C**

### Question 5

Candidates are expected to discuss features of each of the two governance regimes and make links to the known petroleum fiscal regimes:

- Definition of each governing regime
- Main features of each governing regime
- Links between these regimes and PSA, concessions agreements and service contracts

### Question 6

Candidates may refer to UK tax legislation regarding the EPL, and show how the UK petroleum marginal tax has increased to 75%. Also, they may discuss allowances that protect companies from paying this levy, they may refer to Shell oil case. Candidates are expected to discuss impacts of such levy on stability of the UK petroleum fiscal regime and future investments in the UKCS.

Candidates may demonstrate awareness of the Angell article on the UK announcement of a windfall tax on extraordinary oil and gas profits, or other related articles.

### Question 7

State equity and carried interest are agreements which allow a host country to participate in the development of its oil and gas resources and share in the risks and rewards of the project. State equity refers to the government's ownership of a stake in the project company, while carried interest refers to the government's right to a share of the project's profits after the private sector has recovered its costs.

State equity and carried interest are often implemented through production sharing agreements (PSAs), joint ventures (JVs) or service contracts, which are used in different countries depending on their legal and regulatory frameworks.

In a PSA, the host government contracts with an international oil and gas company to explore and produce oil and gas in a specific area. The company bears the exploration and production risks, and the government receives a share of the oil and gas produced. In a JV, the host government and an international oil and gas company jointly own and operate the project, sharing the costs and risks. In a service contract, the international oil and gas company provides services to the government in exchange for a fee.

The tax and economic implications of state equity and carried interest depend on the terms of the arrangement and the tax laws of the countries involved. From the host government's perspective, state equity and carried interest can provide a source of revenue and a means of controlling the development of the country's natural resources. From the international oil and gas company's perspective, these arrangements can provide access to reserves that might otherwise be unavailable and can help mitigate the risks of exploration and production.

However, state equity and carried interest can also have drawbacks. These arrangements can increase the complexity and administrative burden of the project and can result in delays and disputes. They can also create uncertainty for investors and potentially deter investment, particularly if the terms of the arrangement are perceived as unfair or unstable.

In practice, state equity and carried interest have been implemented in various ways. For example, in Nigeria, the government has implemented state equity and carried interest through JVs with international oil and gas companies. The government owns a 60% stake in the JVs, and the companies own the remaining 40%. The companies are responsible for financing the

exploration and production activities, and the government receives a share of the profits after the companies have recovered their costs.

In Iraq, the government has implemented state equity and carried interest through service contracts with international oil and gas companies. The companies provide services to the government in exchange for a fee, and the government retains ownership of the oil and gas produced.

Overall, state equity and carried interest are important tools for host governments to participate in the development of their oil and gas resources and share in the rewards. However, these arrangements must be carefully designed and implemented to ensure that they achieve their intended goals without creating unintended consequences. Effective implementation of these arrangements can contribute to the long-term sustainability of the oil and gas industry and the achievement of national development goals.

### Question 8

Ring-fencing refers to the practice of separating income and expenses from one activity or project from those of another, thereby creating a distinct taxable entity for each activity. In the context of oil and gas companies, ring-fencing rules may be imposed by governments to ensure that income and expenses from the production of oil and gas are treated separately from other business activities, such as refining and marketing.

This means that all costs associated with a block or licence must be recovered from revenues generated within that block. Ring fencing can be applied on different scopes. Some countries ring-fence their oil and gas activities from other activities performed by the same entity (as downstream operations) in the country whilst others ring fence individual projects from other projects held by the same company.

The ring fence may be individual licenses or on a field-by-field basis. In a ring-fencing situation exploration expenses in one non-producing block could not be deducted against income for tax calculations in another block. Under Production Sharing Contracts normally ring-fencing acts in the same way as cost incurred in one ring fenced block cannot be recovered from another block outside the ring fence.

However, if all the projects held by the company are economic profitable it would only constitute a timing issue as the costs will still be recovered but this would happen later on the project in case ring fencing applies.

Disadvantages of ring-fencing for oil and gas companies include higher administrative costs as the implementation of ring-fencing rules may require additional administrative resources to separate income and expenses and to comply with reporting requirements. Reduced flexibility as Ring-fencing may limit the ability of oil and gas companies to offset losses in one activity or project against income in another activity or project, reducing the overall tax efficiency of their operations.

For governments these rules have impact because the absence of ring fencing can postpone government tax receipts as the company that undertakes a series of projects is able to deduct exploration and development costs from each new project against the income of projects that are already generating taxable income.

By introducing ring fencing the government revenue will be accelerated. If no ring-fencing applies this would potentially reduce the (higher) taxes intended to be collected from those operations. Also, if there is no ring fencing and different tax regimes apply to different areas, companies could allocate costs disproportionately to higher taxed areas to reduce tax. One other aspect is that where countries impose progressive taxes, area ring-fencing can mean that companies pay high taxes on “excess profits” from one area, even though they have not made excess profits (or have even suffered a loss) in the country.

The effects of ring-fencing on the taxation of oil and gas companies depend on the specific rules and implementation of the regime. For example, ring-fencing can increase the effective tax rate on oil and gas projects by reducing the ability to offset losses against profits. Conversely, ring-fencing can also increase the overall tax burden of oil and gas companies by limiting the impact of losses in one project or activity on the tax liability of other projects or activities.

Ring-fencing can also impact investment decisions and cross-border operations of oil and gas companies. For example, ring-fencing rules may incentivise oil and gas companies to invest in projects in jurisdictions with more favourable tax regimes, or to structure their operations in a way that allows for more tax-efficient operations across borders.

Ring-fencing may hamper companies undertaking further exploration and development activities due to the inability to claim deductions for such activities on new projects. It may also encourage tax planning if the ring-fenced tax regime is more onerous than the standard tax regime. For example, locating lower-taxed downstream activities outside the ring fence, including in another jurisdiction, or transfer pricing to shift profits outside the ring fence or costs inside the ring fence. Another concern with ring-fencing is that it can be especially complex where one tax (such as a resource rent tax) is ring-fenced but another tax (such as the CIT) is not.

Allowing companies to offset those costs might give an advantage to existing industry players over new entrants with only one license.

Some countries ring-fence their oil and gas activities (usually under corporate income tax) whilst others ring-fence individual projects (usually under special petroleum taxes). Denmark applies ring fencing provisions so that losses from non-oil as gas activities cannot offset profits from hydrocarbon production. In Greenland, there is no field ring-fencing, but oil and gas explorations income or costs may not be offset against income and cost from other activities. Kazakhstan applies ring fencing between Production Sharing Contracts individually and between oil and gas production and exploration and other activities. Norway has a different way of applying ring fencing limitation. In Norway only 50% of onshore losses may be used to offset offshore profits in a clear incentive to prefer offshore exploration. In Qatar which uses Production Sharing Contracts, ring fencing provisions do not allow the communication of costs to offset profits pertaining to a different contract.

The ring-fencing provisions in the UK provide that onshore losses may not offset offshore profits but there is a first-year capital allowance of 100% for capital expenditure from the ring-fenced trade. Cases of oil and gas producing jurisdictions without ring fencing provisions include Brazil, Saudi Arabia and the United States.