THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 3.04 – ENERGY RESOURCES OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Tax and Concession Regimes

Concession regimes apply where the government transfers title to oil and gas to the oil company, and imposes tax and royalties.

The oil and gas company own the oil and gas production, and pay corporate tax on their related profits.

There may be also additional tax or higher tax rates relating to oil and gas production. Norway has a 50% hydrocarbon tax in addition to corporate tax.

The tax regime of individual countries may apply 'ring-fencing' issues. This may mean losses from one field cannot be offset by profits from other fields; or losses from upstream activities cannot be offset by profits from other business activities and vice versa.

Tax and concession regimes are commonly combined with a royalty regime, which imposes charges based on the value of oil and gas production. Royalties are usually paid as soon as production commence.

Corporate tax is levied on oil and gas profits. The tax rate is often higher for upstream oil and gas activities.

Tax and concession regimes may offer incentives such as immediate deductions for development costs, depreciation uplift, and immediate deductibility of exploration and evaluation expenditure
Students may refer to the UK Upstream concession system and any other systems that they are familiar with.

Production Sharing Contracts

Under these production sharing contracts (PSCs/PSAs), the government retains title to oil and gas but gives right to share production, known as profit oil, to the oil and gas company.

The oil and gas company seeks to recover costs in addition to profit oil, known as cost oil.

PSCs are combined with royalty regime based on oil and/or gas produced.

In some cases, the oil and gas company receives a defined share of revenues rather than a share of production.

The government imposes taxes on company's profit oil, but in some cases the government pays taxes on behalf of the company.

The government may opt to acquire interest in the oil and gas field for which the government may have different options to pay for its interest in such field.

The split of oil between the government and the company may be based on fixed percentage or on a sliding scale.

PSC states the allowable costs for cost oil, interest costs are generally not allowable costs.

Allowable recoverable costs are capped based on different basis, for example as a fixed percentage of the annual oil and/or gas production.

PSC may include clauses that exempt companies from certain taxes such as VAT.

<u>Service Contracts</u>

- These could be just service contracts or risk service contracts.
- These apply when the oil and gas company essentially receives a fee for exploration, drilling and production services.
- In regular service agreements, these fees are paid to the contractor irrespective of the outcomes of the development.
- The service agreement regime generally allows a fee to the oil and gas company, this may increase with production.
- The service contract does not give entitlement to petroleum products.
- In Risk Sharing agreements, the contractor risks losses his fee if the venture is unsuccessful.

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Question 2

The Government may increase the corporate income tax rate or special tax rate applicable to the taxable income deriving from the project. It can also introduce new supplementary charges or increase the charges that already apply to the oil revenue (e.g. United Kingdom).

It can delay any VAT refunds due to the company or disregard any utilizable tax losses accumulated by the company in the initial years of the project.

It can introduce new restrictions or customs charges to the import and export of equipment used in the exploration and production (e.g. Ghana). It can introduce new withholding taxes on income streams (e.g. interest payments, branch remittance tax or dividends).
The oil and gas company can include stabilisation clauses in the contract agreed with the Government of n

ational oil company. Stabilisation clauses function as a protection tool of the long-term investment made in a Country and have the purpose of "freezing" the legal and tax regime (applicable to the oil and gas project) in force at the time the contract was entered between the parties. Also, government have been known to enact project specific assurances and guarantees in Statutes, e.g. Nigeria Liquified Natural gas Assurances and Guarantees Law) which has been largely successful in guarantying tax positions and stabilizing the underlying agreements for the project.

With this clause the parties ensure that future changes to the legislation would not affect the project either by including additional duties or by increasing or decreasing the tax which would be due from the sale of oil or gas

The company may also rely on arbitration clauses to start an international arbitration case under one of the recognized arbitration forums for a breach of contract. The way arbitration works is at the start of the procedure each side will nominate their experts and present their arguments before an international court chosen by the parties. In case the company obtains a favourable discussion the same should generally be enforceable against the Government.

Finally, the company can rely upon existing Bilateral Investment Treaties (BIT) signed between States to protect companies from each of the signatory Governments against harmful measures to the foreign investor. The bilateral investment treaties include, as a rule, clauses to protect the foreign investor against expropriation without compensation, unfair inequitable treatment and free transfer of funds.

These clauses can be used by the oil and gas companies to argue there was a breach of the treaty when a Government unilaterally increased the tax rate or created any unlawful tax restrictions to a project.

If any of these solutions is decided in favour of the oil and gas company, there may be a right to compensation or need to remove the illegal change to the previous applicable tax regime.

Example cases:

- RosInvest Co UK Ltd v Russia Federation: This case concerned the bilateral investment treaty between UK and Russia and a company called Yokus. The company was being targeted by arbitrary tax increases that created and increase to 54% from the normal 30% Corporate Income Tax rate. The Tribunal concluded in favour of the company arguing the tax rate increases were arbitrary and confiscatory.

- The Duke Energy v Peru: The case concerned a situation where no new taxes or duties had been introduced but a change in the interpretation of tax laws by the tax authorities had created a similar effect of increasing the tax on the project. The discussion of the Tribunal was around the fact whether a tax stabilisation clause could still apply in a situation where the change in tax treatment did not arise from the introduction of new laws but by changing the interpretation given to the old laws. The Tribunal found in favour of the company that the stabilisation clause could still apply specially in situation where the new interpretation was patently unreasonable.

- EnCana Corpn v Republic of Ecuador: This concerned the bilateral investment treaty signed between Ecuador and Canada. The company argued that by denying refunding any VAT paid to the State, the Government was indirectly expropriating the company of its rights in Ecuador. In this case the Tribunal decided in favour of the host Government by deciding that the indirect expropriation criteria could only be used in situation of extremely punitive or arbitrary amounts confiscated by the State.

- Occidental Exploration and Production Company v Republic of Ecuador: This case concerned the bilateral investment treaty between Ecuador and the United States. The tax authorities changed their tax policy pertaining to VAT refunds. The tax authorities changed their stance by denying any additional VAT reimbursements and requesting the company to return any previously VAT reimbursed previously by the Government by arguing the VAT paid was already considered in the contract between the company and Ecuador. The tribunal decided in favour of the company by arguing the chance of policy discriminated the company against other exporters and sectors.

- Mobil Corporation and Others v Bolivarian Republic of Venezuela: This case concerned where a BIT still applied if a Netherlands entity was interposed into the ownership for the special purpose of obtaining protection from the BIT between the Netherlands and Venezuela. The tribunal decided that this planning was legitimate and that company could benefit from the BIT protection.

- Repsol, SA and Repsol Butano, SA v Argentine Republic: This case concerned the Spain-Argentina BIT and the expropriation of Repsol share in the Argentinean oil company YPF Gas S.A. Repsol was awarded USD 5b in compensation for the expropriation and paid in government bonds. The compensation would only be settled once Repsol derived the amount from the bonds granted under the court decision.

- ConocoPhillips Petrozuata BV v Bolivarian Republic of Venezuela: This case concerned an expropriation by the Government of Venezuela of ConocoPhillips investments in the Petrozuata and Hamaca heavy crude projects and the off shore Corocoro development project. The decision was the expropriation was not in breach of the fair and equitable treatment clause in the BIT but that the Government had breached its BIT obligation to negotiate in good faith for compensation due for the expropriation of these projects, which led to a later compensation decision of USD 8.7b.

- Cairn Energy plc v The Republic of India: This arbitration case concerned the retrospective amendment of tax provisions in 2012 to make sure capital gains tax was applicable to a merger and acquisition transaction from 1962 related to Indian assets. The court rules that the BIT provisions had been breached by the Indian Government and Cairn was awarded damages of USD 1.2b.

PART B

Question 3

Advantages

- Carbon taxes potentially put a limit on the costs of emission reduction where they are transparent, simple, and have a wide coverage.
- They can be quickly implemented by amending tax provisions.
- The related cost of a carbon tax is predictable, which can provide relatively stable price signals to assist businesses and consumers to plan energy spending.
- Predicting cost of carbon taxes offers certainty for investment in energy-efficiency with large initial costs.
- Carbon taxes act as a permanent incentive to reduce emissions because the price of emissions does not change, compared to carbon trading system.
- Carbon taxes are not susceptible to distortions in markets for trading emissions; for example, where companies purchase a large number of permits and resell them for a profit.
- Increasing the cost of carbon-based fuels will motivate companies to switch to clean energy, thus reduce emissions.
- Carbon taxes are sources of revenues, which can be used to compensate those most affected.

Disadvantages

- Carbon dioxide emissions may not decline if the consumption of the goods and services that produce carbon emissions remains unresponsive to price increase.
- The rate of tax to produce the best outcomes is difficult to predict, and may require several changes before becoming effective.
- Lobby groups may be successful in securing exemptions for highly affected industries, and this may substantially reduces the effectiveness of carbon taxes.
- By making fossil fuels more expensive, it imposes a harsher burden on those with low incomes.
- Activities may relocate to a country that does not have carbon taxes, partially where the tax is set at a high level.

Emission Trading Scheme (ETS)

- ETS is a more common approach to reduce GHG emissions.
- ETS is based on establishing tradable property rights to provide incentives to reduce emissions of GHGs.
- ETS are generally placed at the large user stage of the carbon cycle, such as power stations and manufacturing plants; however, rather than placed on upstream activities.
- ETS may set a cap on the total amount of certain GHGs that can be emitted, for example the EU ETS.
- ETS, by offering the ability to trade units, creates a flexibility to improve economic efficiency if it is cheaper to pay others to reduce their emissions as they have more cost-effective alternatives.

- ETS allows revenues to be collected by governments and this can be used to mitigate emissions risks and impacts

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Question 4

For a definition of permanent establishment (PE), we should look to article 5 of the 2017 OECD Model Convention and provisions in the domestic tax law of the jurisdiction where the Contractor is carrying out its works. Article 5(1) includes the jurisdictional threshold test, Article 5(2) and (3) lists examples of typical PE and building site temporary threshold, Article 5(4) includes exclusions to the definition of PE and Article 5(5) and (6) discuss the dependent and independent agent situations.

The OECD defines permanent establishment as a “fixed place of business through which the business of an enterprise is carried on”. This can include a place of management, branch, office, factory, workshop, a mine, an oil and gas well, a quarry or any other place of extraction of natural resources. This concept could also include a building site or construction or installation project that last for more than 12 months.

A dependant agent can also be, in some situations, be considered as a permanent establishment of an enterprise when the agent exercises authority to conclude contracts on behalf of the enterprise. This would however exclude an independent agent working on a general commission or a broker.

Generally, the concept of permanent establishment excludes places of business solely for activities of a preparatory or auxiliary nature (e.g. representative office). For the exclusion to apply the representative office may not have authority to negotiate or conclude contracts on behalf of the enterprise (e.g. subjecting approval to home office approval) and should not be a taxpayer in the host jurisdiction.

For oil and gas service companies it is common to establish a representation office in a specific oil and gas jurisdiction to advertise their services to the incoming oil and gas explorers and producers to try and gather contract leads which will then be negotiated and agreed by the home office contracts team.

This should avoid the oil and gas service company having a permanent establishment in the host jurisdiction. An alternative to this, depending on the preferred structure, the oil and gas service company can incorporate a separate legal company which would register as a taxpayer and hire their own human resources for the project. This would avoid subjecting to tax the profits of the home office oil and service company but would subject to tax the profits arising from work performed in the host jurisdiction.

Tax treaties should also be considered as potential ways to avoid the existence of a permanent establishment, particularly where the domestic provision on permanent establishment are more stringent than the tax treaty definition. Recent OECD BEPS Action 7 should be taken into consideration as it addresses several strategies used for the artificial avoidance of a PE status (e.g. Commissionaire arrangements, Fragmented Contracts and splitting of contracts).

For oil and gas service companies one of the biggest concerns with respect to their operations is how permanent establishment rules interact with local content rules. The local content rules in the jurisdiction could require the oil and gas service company to register or establish a specific presence in country which could lead to a permanent establishment taxation of profits in said country.

Certain structures can be used to prevent the risk of having a permanent establishment. An example of this is the set-up of local joint venture, fully registered and taxable in country, together with a local company or another oil and gas service company. This would avoid a potential issue of the oil and gas service company being considered to have a permanent establishment in the host country and exposing their profits to local taxation. The oil and gas service company can also agree to establish a consortium including local or foreign company.

In setting up these structures, oil and gas companies should analyse potential tax impacts arising from withholding tax on payments to non-residents for income with a source in the country and possible ways to mitigate this impact by using a credit mechanism or having an agreement with the oil and gas company to gross up the payments to include the withholding tax due.

The oil and gas company should also pay attention to the potential existence of rules that allow a foreign company to be taxed in their jurisdiction for work done overseas and the risk those rules could apply if there is not a double tax treaty in place to override said rules but also the application of the attraction principle, as present in the United Nation Model Convention that allows certain source income to be taxed in country even if a permanent establishment is considered not to exist.

PART C

Question 5

Part 1

	£000,000	£000,000
Revenues	200	
Less: Royalty @ 10%	(20)	20
Gross Income	180	
Cost recovery (development Costs)	60 [below 50% of gross income]	
Profit Oil	120	
Split:		
Government 60%		72
Lucky Oil 40%	48	
Corporation Tax @ 40%	(19.2)	19.2
Lucky Share	28.8	
Government Share		111.2

Part 2

If the Government opts to pay corporation tax on behalf of the company:

	£000,000	
Revenues	200	
Less: Royalty @ 10%	(20)	20
Gross Income	180	
Cost recovery (development Costs)	60 [below 50% of gross income]	
Profit Oil	120	
Split:		
Government 60%		72
Lucky Oil 40%	48	
Corporation Tax @ 40%	0	0
Lucky Share	48	
Government Share		92

Question 6

Part 1

Costs of decommissioning are only deductible when they are incurred at the end of an oil and gas field life.

Despite provisions for decommissioning costs being prepared by oil and gas companies, most tax rules do not allow deductions of these provisions for tax purposes.

Some countries require oil and gas companies to establish decommissioning fund where annual payments made to this fund, but these payments are not tax deductible.

The UK tax regime include a decommissioning tax relief where companies are entitled for tax refund for the overpaid tax in relation to decommissioning costs.

If in one year, due to decommissioning costs, a company incurred losses these losses can be carried back to offset against previous profits.

Decommissioning relief allows a company to claim payment related to decommissioning costs.

Transferability of tax history allows companies selling UK oil and gas assets to transfer some of their tax history to the buyer.

The United States tax rules allow deducting costs related to environmental issues such as remediation costs.

Part 2

Operating Lease:

- Treatment as an operating lease for tax purpose depend on establishing that there is not an economic sale of the leased asset to the lessee.

- Payments towards an operating lease are mere rent expenses and therefore are fully deductible for tax purposes.

Finance Lease:

- Only interest payments are tax allowable
- Deprecation of the leased assets are tax deductible

Significant issue for cross-border leasing is whether the payments are subject to withholding tax.

There is a tax issue in relation to leasing and permanent establishment: issues of high value assets.

Question 7

The thin capitalisation restrictions are domestic provisions introduced by different States to avoid a company with a small amount of capital or equity to contract big amounts of debt from a group or related company and accumulate tax deductible interest expense which reduce the amount of tax collected by that State.

The principle behind the restriction is that under normal market rules a accompany with no assets should not be able to secure large amounts of debt from third parties and therefore the use of company loans may be used only to obtain unlawful reduction of the tax normally due in the host jurisdiction. The effect of the thin capitalisation provisions applying is that the company will be denied the tax deduction for any interest expense which exceeds a certain threshold or does not comply with the requirements of the provisions. Generally, any disallowed interest can be carried forward for the following years.

In some countries the rules may be extended to third parties' loans where there is an influence of group companies in the obtaining of said loan. The more common examples of this is the granting of a guarantee by a parent group company or a back to back loan.

Many countries use a debt to equity ratio to determine what would be an acceptable amount of debt under the thin capitalisation provisions. This ratio is normally around the 3:1 mark but it can be higher or lower depending on the jurisdiction.

Some countries complement their thin capitalisation rules with an earning stripping rule. In this case a lower debt to equity ratio (e.g. 1.5:1) is put in place where the company receiving the interest payment is not subject to tax in the same Country as the company paying the interest (e.g. USA).

Other companies use the transfer pricing provisions as criteria for the analysis of acceptable amounts of debts. Where the amount of debt exceeds what would be authorised to an independent party the corresponding interest expense will be disallowed as a tax deduction (e.g. UK).

In some countries the thin capitalisation legislation allows the company obtaining the loan and the tax authorities to enter into an advance agreement on the acceptable amounts of debt either through a specific advance thin capitalisation agreement or through an Advance Pricing Agreement.

The thin capitalisation analysis can also in some cases consider the worldwide situation of the group by comparing the amount of debt obtained by all the companies in a certain jurisdiction where it exceeds a determined percentage of the overall group worldwide gross external debt and disallow any interest expense exceeding this percentage (e.g. UK).

Other criteria used by some jurisdictions to kick-in thin capitalisation provisions is the debt to EBITDA (earnings before interest, tax, depreciation and amortisation) ratio or the debt to assets ratio. In these countries the net interest expenditure in excess of a determined percentage of a company's EBITDA or total assets will be disallowed. This can apply to third parties or related companies' loans (e.g. Germany and Denmark).

Potential alternative structures for funding outside the thin capitalisation provisions include:

- Sale and lease back agreements where the group company buys an asset from its subsidiary and then leases the asset back to the seller. This is normally qualified as an operating lease which generally will not be considered debt under the thin capitalisation provisions.

- Debt factoring where the subsidiary sells its trade receivables for future payments or doubtful debts at a discount considering its book value given that it will receive the payment immediately. It is important this operation follows the transfer pricing provisions and market conditions which would apply between independent parties.

- A back to back loan where the group company intervenes in the relationship between the bank and the subsidiary by guaranteeing the loan through a deposit made with the same bank in another jurisdiction or through the granting of parent company guarantees. In some situations, a fee may be charged to the subsidiary which could also be tax deductible in the host jurisdiction.

- The group company may increase the equity portion of its subsidiary either through cash or assets contributions so that it can comply with any debt to equity ratios applicable under the thin capitalisation provisions.

- The parent company and subsidiary may agree on fees due for financial services as cash pooling treasury management, foreign spot transactions, currency purchase agreements, swap transactions which will not as general rule be qualified as interest expense. However, some jurisdictions may include these fees in the definition of interest for thin capitalisation purposes.

- The group company may provide a smaller loan at a bigger interest rate assuming the transfer pricing principles allow for this rate considering the market and risk aspect of the loan. This is normally something allowed for oil and gas projects considering the high level of risk of the initial investment in exploration of hydrocarbons.

Question 8

In fact, the long lead time and upfront investment of oil and gas project may create a substantial amount of losses in a jurisdiction where an oil and gas company have a specific project or licence. As a rule, these losses are recoverable, either through a cost recovery regime or as accumulated tax losses in a corporate tax system, if the project reaches production phase and can generate enough profits to offset the investment made by the oil and gas company. However, reaching a production phase may take several years to materialize (normally between 5-10 years), meaning the recovery of the accumulated costs may take a long period of time to recover fully. The impacts of the big temporary differences between investment and recovery could also lead to significant cash flow impacts to the company.

A possible structure that may be used to overcome this limitation is the utilisation of a branch structure, where possible, where the head office, or a tax group to which the company is part of, generates enough profit against which these initial losses can be deducted.

This is only possible in situations where tax laws of the head office's jurisdiction company allow for the consideration of branch expenses to be considered in the tax calculation of the company since the company and its branch are the same legal entity. This will not be possible where the head office jurisdiction tax laws treat the branch income and losses as exempt in the origin country. Some countries allow each taxpayer to elect which system they prefer for the treatment of their branches' income and costs, an exemption or taxation of income.

It is important to note that, where the head office jurisdiction allows for the utilisation of the losses under the head office company tax assessment, future income and profits obtained by the branch will also be subject to tax, even if it has already been subject to tax in the host country jurisdiction. This may create double tax situations if a foreign tax credit is not available at the head office's jurisdiction under the domestic tax law or double tax treaty entered between the two States.

The early utilisation of the losses accumulated in the host country under this circumstance may constitute a major cash flow advantage by lowering the taxation of profits obtained in the head office's jurisdiction in which will only be subject to tax when the oil and gas project generates income. Also, should the project never reach a production phase, this structure will allow a definitive tax efficiency for the losses.

The Marks & Spencer EU case jurisprudence and its subsequent analysis by the European Court of Justice on the recognition of final losses of foreign subsidiaries may also be relevant for oil and gas companies resident in the EU, particularly in situation where the foreign branch is wound up after unsuccessful exploration, even in a case where the head office jurisdiction applies an exemption system for branch income and losses. The "check the box" system applicable in the US may also be relevant for oil and gas company resident in the US.

Example jurisdictions

Netherlands: This jurisdiction initially allowed for the consideration of branch losses in the head office tax calculation with claw back of subsequent profits. However, in 2012 it changed that system to an object exemption where losses are no longer deductible, and profits will be fully exempt. However, the Dutch regime allows under certain scenarios the deduction of branch losses where the activity of the branch has been discontinued or sold, treating it as loss on the cessation of business.

United Kingdom: As a rule, in the UK the branch income and losses will be considered in the tax assessment of the head office corporate income tax calculation. However, in 2009, the UK introduced the possibility of companies to make an election to exempt all branch profits and losses from the head office taxation. This election once made is irreversible and can be made on a company by company basis, meaning that in a tax group of companies there maybe companies with different treatment of branch income and losses.

United States: In this country, the branch income and losses are considered for the United States taxation of the head office with no possibility of an exemption applicable to the branch. The domestic tax rules also foresee the possibility of clawing back any foreign branch losses deducted in the United States, in case the branch is sold or transferred after in starts turning a profit. In case of foreign branch profits taxable in the US, a foreign tax credit is available but with limitations, particularly where the tax rate is very high in the host country. This is normally the case for oil and gas taxation. The US also has a “check the box” system that allows for the taxpayer to elect to have a foreign subsidiary treated as a transparent entity for tax purposes. In this case, a subsidiary is treated similarly to a branch for tax purposes in the US.