ATTACHMENT B:

CAPITAL GAINS TAXATION AND INDIRECT SALES

September 24, 2014

OVERVIEW

1. Executive Summary

[To be completed last]

2. Purpose

2.1 This note addresses the issues involved in deciding whether a tax should apply to capital gains in the extractive industries and then, if there is such a tax, the note explores some of the policy and administration issues involved in covering so-called "indirect sales" – whereby assets are not themselves sold, (as in Figure 1 below), but companies or other entities (often resident offshore) holding the assets directly or through further entities are sold (see a simple example at Figure 2). The perception is often that this structuring is designed to avoid capital gains tax on the sale by having the sale occurring at the level of a company in a low or no-tax jurisdiction, rather than there being a sale in a country where the extractive assets are located.

2.2 The issues are basically (i) whether such gains from indirect sales should be treated (by the countrf2eeth

for share) or “farm-out”

3. Status

3.1 This note is for guidance only. It is intended to address the issues in relatively brief form and to help build awareness of them, as well as to help put those faced with these issues in a better position to make policy and administrative decisions in relation to them. The Annex to this note gives a "decision tree" of major policy decisions that arise in this area.

4. Terms Used

UN Model = *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2011)[2]

OECD Model = *OECD Model Tax Convention on Income and on Capital (2014)*[3]

CGT = capital gains tax used generally in this note to include taxation of a capital gain either through a separate specific capital gains tax regime or through the general income tax system. [………………………..]

5. The Issues

(a) ***Should Capital Gains be Taxed?***

5.1 Before the issue of treatment of *indirect* sales arises, a first issue at the policy level is whether to tax gains made when an asset is disposed of *directly*, such as by sale, transferring, gifting or otherwise. Such a tax is referred to as a capital gains tax (CGT) in this note, although while in some countries such gains are subject to a distinct capital gains tax (whether comprehensive[4] or more specific) in others the capital gain will be covered by the general income tax provisions, rather than as a separate tax.

5.2 In a CGT what is being taxed is the *gain* made from the disposal, not the full amount received as proceeds. For a CGT to operate in a particular case, the *person* making the gain will have to be subject to the tax, the *type of asset* disposed of and the *type of disposition* will have to be covered by the tax and the *type of gain* made will have to be of a type covered by the tax.

5.3. It is recognized that policy decisions for or against taxing capital gains comprehensively will inevitably include reasons related in practice to passive assets rather than active assets. Such reasons might not be immediately relevant to the extractives sector, but are relevant to the wider issue of whether a comprehensive tax on

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[2] Available at

capital gains is introduced. The "active" nature of some holdings upon which gains are made is more relevant to the issue considered below at 5.30(ii) of whether there should be an exception for extractive industry assets.

5.4. In policy terms, there are many reasons why capital might be taxed, and not all of them will be directly relevant to sales of extractive assets or even other corporate assets. Reasons usually given *for* taxing such gains when made include the following:

(i) The need for base broadening – with a trend to wider bases and lower rates amongst many countries. The benefits from ownership of property and other forms of capital may not otherwise be as comprehensively taxed as income and consumption and expanding the tax base in this direction may also have lower economic costs than a rise in tax rates on income items;[5]

(ii) The concern that if there is no CGT (or even taxation at a lower rate), income will be shifted to capital, because of the inequities in treatment between income and such gains, thus distorting economic decisions. This is so called lack of horizontal equity between two persons earning the same amounts, one through a capital gain and one through normal income, ,such as wages or normal business profits. In fact a CGT should reduce an incentive, even within the class of capital assets, to investing in those most likely to produce capital gains.[6] Without CGT, there is a lack of neutrality in the system that prefers capital returns over normal income and

enabling government to pursue other tax policy objectives, premised on widening tax bases and reducing standard tax rates;

(v) A comprehensive CGT represents a "safety net" that taxes economic gains that would avoid taxation as normal income. It thus implements a more comprehensive concept of taxable "income" than might apply on normal concepts, such as in case law. In some countries, the law might in fact already reflect this more comprehensive approach to "income tax"; and

(vi) Not taxing such gains (and with no corresponding deductions allowed) will not necessarily speed up the point when income is returned, as other means may be adopted to delay the operation coming into profit.

5.5 Reasons usually given for *not* taxing such gains when made include the following:

(i) That a comprehensive CGT may be too difficult to administer and the potential savings and investment distortions and other efficiency implications that may arise from a partial CGT (such as an over-encouragement to invest in domestic housing if there is an exemption for one's residence) ;[7]

(ii) The difficulty in identifying disposal events comprehensively;

(iii) The complexity of many comprehensive CGT regimes, especially for developing countries, with high costs to comply with them (for taxpayers) and to administer them (for the Revenue Administration). One US Senator stated in 2012 that: "[W]e must consider complexity. Experts tell us that about half the U.S. tax code – more than 20,000 pages – exists solely to deal with capital gains. That complexity, as well as the wide gap between the tax rates on income and capital gains, invites people to use all kinds of shenanigans to game the system"[8] (although this comment also reflects the problems causes by not taxing or differently taxing income);

(iv) Capital gains taxes are in a sense "voluntary" taxes, unlike (or at least more than) income taxes. Only if a taxpayer chooses to dispose of assets will they operate in respect of those assets. Economic decisions as to disposal will therefore be distorted by such a tax;

(v) The "bunching effect" - the gain is realized in the year of disposal sale and potentially pushes a taxpayer into a higher marginal tax rate than if an unrealized gain had been taxed each year. This only applies to taxpayers subject to marginal rates and can be avoided by lower rates, but the latter raises the issue of the equity as between taxation of income and gains and the ability to pay the tax in the absence of actual sale proceeds;

(vi) If the tax operates only on sale rather than on accrual (as it almost inevitably does in countries with a special tax on capital gains, with common exceptions for some assets more readily taxed on accrual),

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[7] See New Zealand Tax Working Group Report at page 11 Recommendation 6. http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax

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there will still be differing treatment to that given to income, and some distortion of savings and investment decisions will remain;

(vii) The difficulty in accurately accounting for the component of a “gain” which is really due to inflation for assets held over many years;

(viii) That on a broad view

international company operating through a Permanent Establishment in the country. Under this scenario, the gain would be integrated in the general income tax base and the corporate income tax rate would apply.

At this point, countries wishing to relieve the tax burden (such as part of the general investment climate, or because they believe sales of such assets may encourage more motivated, better equipped sellers) could allow for tax deductions directly related with the sale, provided certain requirements are met. However, the current trend is for wider tax bases (rather than narrower bases) combined with lower rates.

For CIT purposes, capital gains could also be considered separate from other sources of rent, being taxed at the general tax rate or at a different rate, depending on country policies towards investment. In this regard, lowering tax rates applicable to capital gains could encourage transactions that otherwise would not be viable in terms of tax cost, although it also carries with it the risk of income gains being converted to capital gains.

(c) ***Should Gains in the Extractive Industries Have a Special Treatment?***

5.7. An argument often put against taxing capital gains in this area, although it could be considered an argument against capital gains tax generally and is, on that basis, addressnt 2.02y(i)-4(n)-3(s)-6( )11(ta)-5(x)20(g)-5(e)-3(n)-3(e)-3(r)13H 0 1 383.

5.10. Other countries which do not have a general tax on capital gains often have special extractive industry legislation, such as New Zealand's provisions that in effect ignore the normal distinction between capital and income returns on asset sales so that capital gains are treated as income. The New Zealand provisions include, for example, information obtained as a result of exploratory or prospecting activities. However, there are some exceptions in the case of sales of shares in very closely held corporations.

5.11. One important factor in the general taxation of capital gains in the extractives industry is probably the widespread public view that sales of large scale extractive facilities should bring a return to the government, especially as profits are often seen as "a long way down the road". There are other factors in this debate. There are widespread concerns (whether justified or not in particular cases) about profit shifting, through internal transactions and the engagement of multinational corporations active within international financial and commodities markets, and how this may prevent their operations ever apparently coming into substantial profit. There are also concerns that concessions given on other taxes as an incentive to invest and which are often not public, may in any case mean that the theoretically delayed income taxes will never be paid.

5.12. Even if it is the case that this aspect of capital gains is often not understood, there will be a timing difference between the receipts that may be especially significant for developing countries, and the time value of money advantages the country gaining early receipt. There is also great suspicion (justifiable or not in particular cases) about whether companies that are actually generating profit

(d) ***Farm-out and Farm-in Agreements***

5.13. One distinctive characteristic of the extractive industry is that investors often spread their risks by carrying out large natural resource operations jointly[9]. Often these joint ventures are formed after one party has already engaged in substantial activities to acquire licenses and conduct exploration activities. As a result of such activities, the value of the initial investment in the extraction project may have substantially increased. To attract other investors to share in the cost and risk of developing the project, the initial investor will need to transfer a portion of the project to the investor. How a country's tax system treats the formation of a joint venture to develop an extractive project will often have consequences on the decision to go forward with the development opportunity.

5.14. One aspect of this sharing of risks is that of "farm-out" agreements. These are agreements where a party with an oil or gas interest termed "the Farmor" agrees to assign part of an interest to "the Farmee" in exchange for certain contractually agreed services. Typically these services include drilling a well to a certain depth, in a certain location, in a certain timeframe and the agreement also typically stipulates that the well must obtain commercial production. After this contractually agreed service is rendered, the Farmee is said to have "earned" an assignment. This Assignment comes after the services were completed, and is subject to the reservation of an overriding royalty interest in favor of the Farmor.[10] From the Farmee's perspective these are known as "farm-in agreements".

[9] Jack Calder (2014). *Administering Fiscal Regimes for Extractive Industries: A Handbook.* Washington, D.C: International Monetary Fund.

[10] Austin W Brister (2013). "Farmout Agreements: The Basics, Negotiations and Motivations". Available at: http://www.oilandgaslawdigest.com/ogagreements/farmout-agreements-basics-negotiations-motivations/

(e) ***Taxation of gains from "indirect sales" as an option***

5.15. It is a policy decision for each country whether it should address gains made from indirect sales, but there are increasing expectations, including from the broader citizenry, that if direct sales of a mine or other extractive facilities are subject to taxation on the gains made, an indirect sale should have the same effect in revenue terms, despite the lack of any change in the direct ownership of the assets, and the separate legal entity status of distinct companies in the chain of ownership. The value of such extractive facilities is no doubt one reason for the particular focus on such facilities as is the diminishing nature of the extracted resources. It is fair to say, however, that the informational and(l)-4(uo87a8)-3(n)-3(f)-3(o)-3(n)-3(g)9(e)9(i)-6(n43(s)-6( )11(i)-)-6(o)-exh4(a)-5(nf7(h4(d-4(s)-6(h)9(i)-4(n)-3(g)-3()-6-

However, in indirect purchase transactions the purchaser would as a general rule not be the entity conducting the extractive business and should not be able to claim a deduction, unless it on-sells the indirect interest. In that case the actual purchase price will be deductible against sale proceeds of the indirect interest in the extractive business.

If countries frame their indirect sales legislation relatively narrowly

(h)

5.28. Assuming domestic law on taxation of indirect sales is in place or is being kept open as a possibility, the question is then whether the treaty limits such an exercise of taxing rights and thereby overrules the legislation to some degree. To consider that issue, the provisions on Capital Gains (often Article 13) of a specific tax treaty have to be studied:

b.

partnership, trust or estate. This is merely repeated in the Commentary on that Article, without more elaboration of how it is to be applied in practice..

b. The OECD Commentary on Article 13 provides at paragraph 28.4 that: "paragraph 4 allows the taxation of the entire gain attributable to the shares to which it applies even where part of the value of the share is derived from property other than immovable property located in the source State. The determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).

c. It seems that practice on whether countries use Fair Market Value or Book Value as the valuation method is very varied. Some countries have a blended requirement that allows the latter to be used in some circumstances unless there is any reason for a shareholder to suspect that it does not fully reflect the underlying value of the immovable property, as compared with other assets. Many, probably most countries do not seem to include intangibles in the calculation, perhaps in part because of the difficulty of accurately calculating this.

(vi) Whether there should be an exception for shares quoted on a [relevant] stock exchange:

a. This is sometimes used as a mechanism to reduce compliance costs (and administration costs) in cases where there is a genuine share market transaction. It would usually be defined to include at least the share markets of the two treaty countries, and in the case of domestic legislation operating even without a treaty, the legislating country's stock exchange(s) . However, critics would say that this has no bearing on ensuring that indirect sales are taxable in the same way as direct sales.

b. The specific exception for such on-market sales would only need to be reflected in the domestic legislation if there is a taxing right such as under Article 13(4), since it narrows rather than extends the treaty right.

(vii) What should be the percentage of the gain taxed:

a. The provisions in the UN and OECD Models allow, when the company meets the requisite test for domestic immovable property holdings, for taxing of the whole gain, not just the percentage of it relating to immovable property in the taxing jurisdiction, but some countries provide a moderating effect in their domestic laws so that only that percentage is taxed.

(viii) How can abuses be addressed within Article 13(4):

a. Some countries provide that the gain will be taxable if the percentage test for immovable property was met at any time in the year before sale – this is to prevent manipulation of indirect assets held temporarily when the sale occurs.

b. The question has sometimes arisen about whether Article 13(4) may still apply, if a company borrows money just before the share sale to dilute the percentage of assets constituted by immoveable property. Some countries take the view that as the OECD Commentary states at paragraph 28.4 that debt should not be taken into account in the valuation of the property of the company, the moneys borrowed should not be taken into account to dilute the percentage of immovable property interests. Others more

6. Issues of Identification

6.1 The first issue is how does one even know about the indirect sale, especially an overseas sale (as it usually will be)?

(i) It is possible that information may come to light in an automatic exchange of information (though developing countries at this stage do not have many such arrangements) or by a spontaneous exchange from another country, but this is not likely to happen often either. Where treaty relationships exist information could be sought from treaty partners, but that would usually only happen after there was an initial awareness of the sale, and at least some of its details.

(ii) Officers in the revenue collection agency should keep up to date with industry news and conducting regular internet searches for sets of key words such as the names of mines, the word "mine" and the country name have some value, but are necessarily reliant on luck. Commercial databases may assist as might details of foreign takeovers required under domestic law or notifications of changes required under extractives legislation. In one Chinese case a public announcement was found on the website of the buyer, announcing the completion of the acquisition of the Chinese company, but without mention of the intermediate holding company, a Hong Kong special purpose vehicle with little substance.[12]

(iii) Other potential pointers to an indirect sale might include changes in enterprise names, changes in directors, and changes in tax auditors.[13] It has been noted that companies that have been listed on international stock exchanges, subsequent to structuring, are more prone to detection, and that accountants may be required to "provision" for a potential tax liability of the selling entity.[14]

(iv) Some countries have imposed reporting obligations on companies to report when they are indirectly sold or where there are major changes in shareholding or on shareholders (usually only those in a control situation – because the requirements can cast heavy obligations on the shareholder to know what business the company is conducting) to report to authorities a sale affecting local property.

(v) To be effective, even requirements to notify of major shareholding changes (say of those above 10 per cent) would need to provide that changes over a period of time (12 months or longer in some cases) to prevent several sales of 9 per cent in a short being time not having to be reported. The OECD BEPS Action Plan notes this issue in its discussion paper on Action 6:[15]

> 47. Art. 13(4) allows the Contracting State in which immovable property is situated to tax capital gains realized by a resident of the other State on shares of companies that derive more than 50% of their value from such immovable property.

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