[1] The first draft has been prepared by Tomas Balco with valuable contributions from Jan de Goede, Nana A. Okoh, Susana Bokobo Moiche, and Álvaro de Juan Ledesma as well as the UN Secretariat and other members of the Subcommittee for Extractive Industry Taxation Issues for Developing Countries. Ilka Ritter and Viktoria Wöhrer have contributed to the revision of the first draft.

Executive Summary / Purpose

The extractive industries play an important role in the process of sourcing natural resources which are critical for the development of many economies. Both developing and developed countries are actors in the process of natural resource extraction – both as host countries to the extractive activities and also as countries where the extractive industry companies have their head-offices, raise capital and make strategic decisions. Extractive activities often include a cross-border element due to global business models and integrated value chains. They are undertaken by investors, license holders, service providers and suppliers who are often not resident in the source country. In this context, a number of international tax issues arise.

This note reviews tax treaty articles which are potentially affected by economic activities of the extractive industries and highlights the issues that countries, especially developing countries, may wish to take into consideration in the process of designing their tax treaty policy, (re-)negotiating their existing tax treaties and in applying their respective tax treaties. Whereas this guidance note deals with tax treaty issues especially from the perspective of the UN Model Tax Convention, reference is also provided to the OECD Model Tax Convention where appropriate. In addition, some tax treaty provisions which depart from both the UN and the OECD Model and address specific problems related to the extractive industries are presented.

The issues raised in this note affect both the tax revenue of the jurisdictions involved and the tax position of companies involved in the extractive activities.

Status of this Note

This note is for guidance only. It is intended to address tax treaty issues in the extractive industries in brief form, to raise awareness of potential challenges as well as to aid those faced with these issues in a position to make policy and administration decisions. Some of the specific areas related to the application of tax treaties – for example, aspects on taxation of capital gains and permanent establishment issues – are to be further elaborated in separate guidance notes.

Terms Used

Consortium Joint venture arrangement of several investors, who may pool the capital and expertise to jointly exploit and share the risks connected to exploiting a particular extractive project.

Double tax treaty (DTT)

not be liable to the income tax of the other country unless it has a "permanent establishment" through which it conducts business in that other country. Even if it has a PE, the income to be taxed will generally only be to the extent that it is ‘attributable’ to the PE.

Production Sharing Agreement (PSA) Contract regulating relationships between the states and oil companies with regard to the exploration and production of hydrocarbons. The concession is assigned to the national oil company jointly with the foreign oil company which has exclusive right to perform exploration, development and production activities and can enter into agreements with other local or international entities.

Royalty In the extractive industries, the term ‘royalty’ refers to the obligatory payment made by the operator of the extraction project to the state as a compensation for the extraction rights. Royalties are generally calculated with reference to the type, quantity, quality and/or value of the extracted mineral resource as a percentage of the gross volume or value of the production (i.e., costs do not reduce the base), and are due once production commences. The term ‘royalties’ as defined under Article 12 UN Model has a different meaning and refers to the payment for the right to use property (in case of the UN Model both tangible and intangible).

Service Provider/Subcontractor A Service Provider/Subcontractor is a company or individual providing various types of services and other supplies in the framework of the extractive industries.

Treaty Shopping The practice of structuring an investment/business activity so as to take advantage of

It needs to be stressed that tax treaties always operate in conjunction with domestic law. Tax

Countries that neglect to pay special attention to the s

Overview of the Extractive Industries Life-Cycle in Relation to Cross-Border Tax Issues

Extractive industry activities often take place over a long period of time. The different critical activities can be divided into five main stages: 1. Contract Negotiation, 2. Exploration Activities and Evaluation, 3. Development of the Infrastructure, 4. Extraction, Production and Export, and 5. Abandonment and Decommissioning. These stages could be further separated, for example the abandonment and decommissioning can be considears twJ -0.012 Tc Tw 0.333 0 Tdyr333 0 Td [(E)-0.7en(

Table 1: Stages, Activities, Actors, Domestic Tax Issues and Potential International Tax Issues

		Actors	Domestic Tax Issues	International Tax Issues

	resettlement issues.			
Extraction, Production and Export	Extractive activities take place on a commercial scale. Resources are processed and/or sold/ transported/exported	Extraction Company Subcontractors for Processing, Transportation, other Services	Extraction taxes (royalties, share from PSA, hydrocarbon taxes, corporate income tax, hydrocarbon tax); e	

Personal Scope of Tax Treaties

The general principle of Article 1 is that tax treaties should apply only in respect of the persons (natural personals as well as legal persons, such as companies) that are residents of one or both of the Contracting States. Article 4 subsequently provides a definition of who is a resident of a Contracting State for treaty purposes and in doing so the Article refers to the domestic law of the Contracting States.

Many extractive projects may be organized in the form of incorporated, but also in the form of non-incorporated joint-ventures (also known as consortia). Incorporated join

In light of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project,[8]

calculated as a percentage of the gross volume or value of the production and are due once production commences. With the exception of some countries[9], royalties are not levied with reference to profit and therefore they would not be considered to constitute tax on income or capital, which could be covered by the scope of the tax treaty.

Production Sharing Agreements

Production Sharing Arrangements generally provide a formula for sharing the production between the investor and the government. heo(y)22.3(t)rnmwi.7(v)]T1.7(v)]T’ing

Export		extracted resource	
	Bonuses and Rentals	Same as bonuses and rentals above	Same as bonuses and rentals above
	Production Sharing payments	% of production paid to state	Usually not, unless designed as tax on income/% of profit
	Profit Taxes and Excess Profit Tax	Tax on Income/Profit	Yes
	Export Duties and Export Levies	Tax on Value of Exported Resource	No
Abandonment and Decommissioning			

If these special types of taxes are not covered by tax treaties (i.e. outside of their scope), the host states can still levy these taxes

The question may arise, whether where such extended definition (continental shelf and exclusive economic zones) is omitted, the taxes levied on the activities taking place within the jurisdiction of the Contracting State fall within the scope of the treaty and consequently if the country of source is potentially limited in the exercise of its taxing rights and the country of residence is obliged to eliminate potential double taxation.

In the case where the extended definition is not included in the treaty, one could conclude that the tax treaty does not apply to the taxes levied by the host state over such territories and no limitations of host state taxing rights arise, but equally no obligations to eliminate the double taxation arise for the state of residence. Therefore some states may deliberately omit the inclusion of such an extended definition.

Countries with extractive resources that are in the process of negotiating tax treaties may want to decide for or against including an extended definition of the territorial scope into their treaty, weighing the costs of potentially giving up source country taxing rights with clarity for both the tax administration and tax payers.

Business Profits and Permanent Establishment Issues

The profits from commercial activities will usually be covered by Article 7 – Business Profits, unless other articles apply to the specific type of income. Article 7 provides exclusive taxing rights for the state of residence of the recipient of the income, unless the enterprise carries on business in the state of source and such activities are conducted through a permanent establishment. In such a case, profits from such activities, which are attributable to the permanent establishment, may be taxed in the country of source. If economic activities do not fall within the definition of what constitutes a permanent establishment, the profits from such activities may only be taxed in the country of residence. This general rule and principle may not be suitable for the policy objectives of some countries that host extractive activities and therefore they may include specific provisions into their bilateral tax treaties, which may further alter these default rules of Article 7 and Article 5 to address these specifics.

The provisions of Articles 7 and 5 will be relevant for different actors and players in the extractive industry sector. These provisions will be important for the investors and operators, who may operate in the host country without having established incorporated entity[11], since existence of permanent establishment will determine, whether the country may levy tax on profits made by the investor, but these provisions will be also relevant for the various non-resident service providers and suppliers to this industry.

The term "permanent establishment" is an important threshold that is central to Article 7 and is defined in Article 5. However, it is also critical for the operation of other articles regulating the taxation of income such as dividends, interest, royalties, capital gains, income from employment as well as other income and capital. While this note addresses issues relevant for tax treaty

[11] Some countries may require that the investor to be incorporated within the country to obtain a licence to explore or extract resources, e.g. Nigeria and Brazil.

negotiations, there is a specific Guidance Note that is being drafted to address the practical aspects of permanent establishment concept in relation to extractive industry.

"*The term 'permanent establishment' means a fixed place of business through which the business of the enterprise is wholly or partly carried on*" (Art. 5(1) UN Model). The condition that the place of business, or the use of it, has to be permanent is explained in the OECD Commentary (cited in the UN Commentary) in the sense that a PE can be deemed to exist only if the place of business has a certain degree of permanency (i.e. if it is not of a purely temporary nature). A place of business may, however, constitute a PE even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried out for that short period of time. It is sometimes difficult to determine whether this is the case.[12]

In addition, Art. 5(2) list specific operations that prima facie constitute a PE. It especially includes "*a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*" The OECD Commentary to this paragraph (also cited in the UN Commentary) states that "*the term 'any other place of extraction of natural resources' should be interpreted broadly*" to include all places of extraction of hydrocarbons whether on or offshore. This is the only specific provision specifically addressing the extractive industry activities and the illustrative example indicates that extractive activities carried out by non-resident investors and subcontractors will usually constitute a PE in the .3(s)27.9(p)28.7(e)1.3(of)J 03y0.08 0

Accordingly, some countries exercise this policy option and include exploration activities in Art. 5(2) of their tax treaties.[14] Without providing any further rules, the general provisions of permanent establishment definition (Article 5(1) will apply to such exploration activities.

Alternatively, a treaty could provide for exploration to be a PE in a separate provision.[15] Such a provision may either provide that the exploration activities (onshore or offshore) deem to constitute a permanent establishment irrespective of the duration of activities. Other countries will include provisions with a specific time threshold[16] – e.g. 30 day rule, based on which the exploration activities deem to constitute permanent establishment if they continue for more than 30 days.

Both the UN and the OECD Model also have a provision dealing with construction sites. In this respect, the two models however differ from each other. Whereas Article 5(3) of the OECD Model states that "*a building site or construction or installation project constitutes a permanent establishment if it lasts more than twelve months*", the UN Model gives the host country broader taxing rights by providing for a six-month duration test for building and construction PEs and expressly includes supervisory activities. This may be especially relevant in the extractive industries, since significant construction and installation of infrastructure takes place in the development stage. In the oil and gas industry it is commonly understood that the well is being constructed, since it requires significant other construction activities beyond the mere drilling activity, including concrete works, welding, cementing, etc.

Furthermore, some countries also deem a PE where 'substantial equipment' is used by, for or under contract' with the taxpayer.[17] Where countries introduce such provisions, interpretation issues may arise in respect to the term 'substantial equipment'.[18]

Taxation of Services

As was noted above, significant part of the activities related to exploration, development of deposits and extraction activities are performed by various service providers and suppliers. The services carried out may encompass the drilling of wells (directional drilling, tubular running, cementing, etc.), logistics (communication, helicopter, logistic base, etc.), construction work, including maintenance and repair work, preventive maintenance, engineering and consultancy service, catering, supply and hotel services. This naturally leads to questions, such as to what extent can the profits earned by the service providers and subcontractors be taxed by the source state, where these activities take place.

The host country is usually only allowed to tax a service fee paid to a subcontractor under the applicable tax treaty if (i) the non-resident subcontractor has a permanent establishment in the host country; and (ii) the service fee is attributable to the permanent establishment.

[14] This can for example be found in Art. 5(2)(f) Canada – Kazakhstan tax treaty dated 25 September 1996.
[15] This can for example be found in Art. 5(3)(3) Australia – China tax treaty.
[16] See for example Article 21 of the Nordic Convention.
[17] See DTT of Australia, Ghana and other mining countries; for example Art. 4 (3) b Australia – Singapore DTT; Art. 5 (3) c Australia – Switzerland DTT.
[18] See Australian Taxation Office, 0 Tw 1 Td .055 1 Td 468.51 Td [(T)5 Tm ( )Tj 0.06 57.5(e)966.4(e)96.56.4(Tw .D)-263(e)| EM

important that the UN Model maintains A

permanent establishment or not.[24] This also has relevance for the ability of the host country to tax the capital gains from sale of such licenses.

International Shipping/Air Transport

While Article 8 takes away the taxing rightn.3(A)-4.(g)12.(0 TdCID 2 >y)-3.6(n3(ne.7(a)20.3(x)h7(i)-29.7.7

Articles 10, 11, 12 – Dividends, Interest, Royalties

These articles may not raise specific issues related to the extractive activities; nevertheless, they may still raise issues pertinent to developing countries and tax base erosion.

There is a specific difference between the UN and OECD Models in Article 12 – Royalties, where the OECD Model allocates the exclusive taxing right to the country of residence, while the UN Model allocates the right to tax royalty to the country of source with a limited tax rate. In addition, the definition of Royalty in Article 12, paragraph 3 of the UN Model extends the definition to include payments for the use of scientific, commercial and industrial equipment – thus permitting the country of source to levy tax on both – payments for the use of intangible property and the h..s(229000.0w25677.27. ()-229.3.

In this regard, it is also appropriate to highlight the existence of Article 13(5) of the UN Model, which permits the country of source to tax the income from capital gains also where the property does not derive more the 50 per cent value from the immovable property. The provision however applies only in direct transfers of shares, so it may not be effective in the indirect transfer of shares situations.

In case Article 6 does not include shares in companies deriving their value from immovable property, the same result can be achieved by Article 13(4) of the UN Model. It allocates the right to tax indirect

is deemed immediately or after a short period of time (e.g. after 30 days) and thus no further changes are required to the tax treaty provisions. The host country will be able to tax the salaries of the personnel engaged in providing the services and activities, where these activities constitute a PE including the deemed PE as a result of specific activities related to the extractive industry.

Articles 16 and 19 – Director's Fees and Government Service

In respect of Article 16 – Director's Fees, it is advisable to follow the UN Model, which extends the application of this article also to the top management of companies.

mIDiese One specific issue that may arise e 62 Tw 110ecocp3.7(e)01Tj -0.033(x)-72691p7.7(e)b.9(o)10.4( )-67

The specific issue related to the extractive industry would be the obligation of the country of residence to eliminate double taxation, where the country of source was entitled to levy tax on income or capital. Specifically, the question will arise, whether the specific types of taxes levied on the extractive activities fall within the scope of the tax treaty, in accordance to Article 2 and whether the country of residence has to provide credit in respect of the particular type of tax. Countries of residence may seek to limit the maximum credit available as can be demonstrated from the example below.

Article 24

industries. However, if this higher tax rates apply irrespective of the residence of the investor or the head office of the extractive company, they are not to be considered as discriminatory.

Similarly, where the host country levies a special branch profit tax, the issue may arise, whether this branch profit tax is in accordance with a tax treaty. The country practices indicate that many countries chose to clarify these issues in Article 24(3), through a special provision inserted in Article 10 (Dividends) or in the protocols to the tax treaties.

Situations, where the host country opts for indirectly taxing the non-resident subcontractor by denying a deduction for the payment of the fee at the level of the payer may be also considered discriminatory if similar payments made to resident recipients are deductible.

For more information …

E. Reimer & A. Rust, Klaus Vogel on Double Taxation Conventions

C. Brown, Permanent Establishments and the Mining Industry – A Roadmap to the Taxation of Resource-Based Activities under Tax Treaties, 18 Asia-Pacific Tax Bulletin 1, p. 5 (2012)

See L. Burns, Income Taxation through the Life Cycle of an Extractive Industries Project, 20 Asia Pacific Tax Bulletin 6, p. 410 (2014)

IMF, The Taxation of Petroleum and Minerals: principles, problems and practice, edited by Philip Daniel, Michael Keen and Charles McPherson (2010)