Attachment to Coordinator Paper:
(4) Guidance Note on the Tax Treatment of Decommissioning for the Extract.08a.Tw.12

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1 Executive Summary/ Purpose

The extractive industries have an important role in supplying key resources needed for the development of any economy. The mining and the petroleum industry are the two main extractive industries,

2 Status of this Note

This note is for guidance only. It is intended to address the tax treatment of decommissioning in the extractive industries in brief form, to raise awareness of potential challenges as well as to aid those faced with these issues to make good policy and administrative decisions.

3 Terms Used

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4.2 Key drivers in determining decommissioning principles

The key drivers, which affect

Implementation of remedial measures to manage ESHS issues remaining from operations or resulting from cessation of operations and decommissioning activities

Restoration of the site to an agreed-upon use and quality in line with the expectations of

5 Principles of a Decommissioning Regime

5.1 Guiding principles

The following guiding principles are suggested for the design of the overall decommissioning regime.

5.2 Politics, public concern and r eputation

As discussed above, the effects resulting from the political and community reaction to the closure of major facilities in a community can heavily influence the decommissioning process. If not properly managed, a destructive distrust can develop between the principal players. If any indication of non-disclosure emerges, this can lead to catastrophic outcomes, such as the Brent Spar incident.

It is advised that the selection of the decommissioning/closure option must be managed in a transparent process with a fully developed public audit trail. The three major compon

challenge to balance the total removal with environmental concerns, safety, technical feasibility, cost, etc has forced an evolution in the decommissioning law and regulations.

The optimal solution may not be the total removal of a specific oil and gas facility, but a carefully balanced compromise within the relevant legal framework. It is important that Governments incorporate flexibility in their national legal framework. The present international laws and conventions, listed below, are applicable in the majority of the African Countries and have built in such flexibility.

United Nations Convention on the Continental Shelf (Geneva Convention), 1958

Third United Nations Convention on the Law of the Sea (UNCLOS III), 1982

The International Maritime Organisation Guidelines and Standards for the Removal of Offshore Installations and Structures on the Continental Shelf and in the Exclusive Economic Zone (IMO Guidelines), 1989 Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matter (London Dumping Convention – LDC), 1972; signed by Angola, Cote d'Ivoire, Egypt, Equatorial Guinea, Kenya, Libya, Morocco, Nigeria, Sierra Leone, South Africa, Tanzania, Tunisia.

Protocol to the Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matters (London Protocol), 1996; signed by Angola, Egypt, Kenya, Sierra Leone, South Africa

Executive Decrees and specific Local Government Agreements (often with industry) all must be provided for as part of an overall national program for acceptable mine closure. These are in addition to specific instruments under Environmental and Mining legislation that require putting in place policy and

It is often the case that inadequate and unproven fiscal regimes exist in countries where post-closure sustainable development presents the greatest challenge for the government. One of the key components for successful decommissioning is a taxation system which facilitates this process.

In summary, the sector law and regulations for decommissioning provides the overall framework within which the taxation rules for decommissioning musriem ec fcecg m5(g m6-.0)-6.40 Tc 1 T211.04 TD7( )TjEMC 1 T111.04 n

Key questions in a stakeholder engagement process;

- Which stakeholders to engage
- How to engage
- When to engage

Well managed stakeholder engagement can improve decommissioning plans and make the whole process more efficient. Stakeholder engagement can also make the outcomes of the decommissioning

5.7 Environmental impact

Once closure and decommissioning strategies have been decided upon, it will be necessary to develop an Environmental Impact Assessment for the relevant options, rank the options and to communicate the outcome to various stakeholders. No mine shut in

6 Regimes for Delivering Decommissioning P

In the event that an installation crosses two or more countries, the following outcomes are possible at the respective times of the project's life cycle:

a. Field in planning phase.
    i. Treaty signed including handling of decommissioning and final disposal between the involved countries before the decision to development the field.
    ii. Treaty signed, but decommissioning and disposal not included in the Agreement.
b. Field in operation.
    i. Treaty signed with the respective countries, decommissioning and disposal included in the Agreement.
    ii. Treaty signed, but decommissioning and disposal not included in the Agreement, 1 Tw 0.815 0inh5.9(h)7(t)-6((m)1.6(e)-6(n)-0.80.7(e)4.9)-3.2(7)37.9p

7 Quantification of Decommissioning Costs

7.1 Framework of q uantification

International and regional legal frameworks drive the cost of decommissioning and remediation, assuming that the country has ratified the relevant treaties and agreements. This international legal framework defines what must be removed, when it must be removed, to what degree the sites need to be reclaimed and rehabilitated. But these laws and regulations are relatively abstract and rely on, when available, more detailed national legislation, regulation and guidelines.

These country specific laws, regulations and guida(n6.8(e)-6(2(e)(v)-2.5(ed7(e)-6(c)-4.3(a)-3.3(n)-0.8(e)-6(gu)- u7(s)-4

operators make these calculations in-house with their own cost models that might be based on benchmark data. Other operators use external engineering consultants to make cost estimates. For

practice of cost estimates, which makes it challenging to compare estimates, even for similar types of installations. The reasons are largely different legal requirements in various countries and established practice.

Owners/licensees are generally responsible for developing cost estimates and funding mechanisms. They are required to submit the estimates to the regulator for review or approval.

The types and extent of assumptions and boundary conditions typically applied in cost estimates have a major effect on the overall costs. Regulators can specify boundary assumptions as a way of ensuring completeness in the coverage of the cost estimates, as well as the quality of the analysis. This could limit cost-underestimation and over-provision, given that the regulator has the right knowledge and competence.

Standard definitions of cost items should be established. Development of an international guideline or standard list of items for cost estimation, could establish more consistency and comparability if countries used common or comparab.4(p)-3(ara5(t)-o)-6.6(v)-5.cymes.2(lis)tTc 0.dy-aes4-0.7(a)-3imb.4(p)-4itR66(k)-5.-6.4(e)0.2(e

8 Tax Policy Issues in Decommissioning

8.1 Importance of good tax policy and law design

There is a need to understand the wider policy towards decommissioning in order to avoid impeding

b. Entity segregation for tax purposes, thus restricting loss transfers
c. Restrictions of transfer of the resource asset to late life developers.

6. Promote only a standard decommissioning approach rather than a bespoke approach.
7. Have an overbearing effect on the selection of the method of developing resource projects, thus influencing the ultimate decommissioning method and approach.
8. Influence the premature shutdown of the infrastructure which will result in premature decommissioning of assets.
9. Stop alternative uses of resource fields and therefore promote premature closure or delay decommissioning.
10. Advantage multi field investors over single field investors which will reduce the investor pool.
11. In case of Joint Development Areas (JDAs), different tax rules in the partner jurisdictions will add to the risk that incentives and obligations are misaligned, e.g. that costs are split disproportionately among the countries involved.

8.3 Policy approaches to tax deductibility of costs

8.3.1 General

As a general principle, qualified decommissioning costs should be considered a business expense and the corporate income tax system should allow deduction from taxable income. The adoption of a clear decommissioning regime, with quantification of costs, should enable an outright deduction for such expenditure. Such treatment will also avoid technical arguments as to whether decommissioning expenditure is revenue or capital in nature. Deductibility can be considered valid under general principles; as the expenditure is incurred at the end of a project, the contractor does not use the expenditure to earn income and such costs may simply be considered operating expenses.

While decommissioning costs are quite significant, these costs are usually incurred at a time when there is little or no income from the project. Such costs therefore result in a final or terminal loss in relation to that particular project. The core challenge is therefore ensuring deductibility of costs where there is no income for the losses to be applied against.

Where the operator has a single project in the country, the loss cannot be carried forward to a subsequent tax year because the holder of a mining or petroleum right ceases to have income-earning operations in the country. Where the operator has multiple projects, deductibility of such costs may still be restricted under general rules, e.g. if the country in question uses a ring fencing approach, i.e. restricting taxability and deduction respectively of income and expenses from a project to that project only.

8.3.2 Recognition of decommissioning costs for tax deductibility

As outlined in Section 7 above, determination of the estimated costs of decommissioning is a technical matter, for which the best expertise probably lies within the appropriate resource ministry (oil and gas or mining). It is recommended that the entire deductibility question should be conditional upon approval of the estimated costs by the resource ministry and that there should be a mechanism for the resource

ministry to notify this to the tax administration. Governments may choose to address this matter by a regulation.

It is also important for tax policy makers to recognize that the decommissioning costs estimate is an estimate only. The actual decommissioning costs at the end of the project life may be quite different due to changes in technology, the development of more innovative solutions, heightened environmental standards at the end of project life compared to the start, etc. There thus needs to be a degree of the

be considered. It is recommended that governments address the issue of such a clearance through regulation.

There may be a cost of providing such a guarantee, either in the form of an insurance premium, or an intercompany fee to the parent company or an affiliate of the operator. This cost should be a deductible expense for the operator; in the case of an intercompany fee, the cost should not exceed the ordinary arm's length cost of the guarantee.

8.5 Current cash flow/ existing operations

8.5.1 General

Any costs actually incurred within an ongoing project towards its ultimate decommissioning should be allowable for income tax purposes.

This treatment can also be extended to a project which is at the end of its useful life where the holder of the concession has a number of ongoing operations in the country. Decommissioning costs of such projects could be met from current cash flow. Such costs can then be allowed as deductions against income from other ongoing operations. If this policy choice is made, this treatment should be made explicit in the corporate income tax legislation to avoid disputes about the appropriateness of the deduction.

There are two policy questions to consider in determining allowability of such costs across projects:

1. Do the general tax rules allow for an entity approach, i.e. where the sum of all activities of a single corporate entity are subject to corporate income tax at the same rate, or is there differential treatment provided for different sources of income?
2. Are there provision for ring-fencing of income and expenditure from natural resource extraction projects?

Deduction on a cash basis – i.e. as the decommissioning expenditure is incurred – is current practice in Australia, Denmark, Norway and the United Kingdom for the oil and gas sector.

8.5.2 Use of loss carry-backs

In most tax systems, tax losses are carried forward to the next tax year and allowed as a deduction in that year. However, the use of a loss carry back may be considered as a way to give relief to the operator in extractive projects. A special provision can be made in the corporate income tax law to allow loss carry-backs in the case of a terminal loss arising from mining or petroleum operations. This will involve reopening the tax assessment for the previous year, or a number of years and will typically result in refunds of taxes paid for such year(s).

Policymakers will need to be conscious of the government budgetary rules, and availability of funds for giving refunds; due to these issues, this may not be a viable option for many developing countries. Further, consideration will need to be given to the administration of the carry-back to ensure that it is not abused. If, however, the budgetary and administrative issues can be resolved, the use of loss carry-backs can be an effective means of granting relief. This is particularly true when ring fencing applies;

also, it allows for accurate deduction of the actual costs incurred, and avoids the issues of recapture of

The structure and management of the fund itself. There are a range of options for this, discussed further below. However, the structure set up should meet some specified principles, e.g.:

- the fund or an account must be established for the specific purpose of providing for the future payment decommissioning or remediation costs
- there should be appropriate oversight including from the relevant sector ministry
- there should be independent oversight outside the government or the industry, e.g. a retired banker, industry experts, etc.
- the requirement to establish the fund should be provided for under the relevant mining or petroleum right
- There should be provision for separate holding of the funds in trust, the appointment of investment managers and guidelines for prudent investment of funds held.

The fund may be organized in one of different ways:

1. For countries with a common law background, the trust legislation may be used to create an independent trust on a per project basis.
2. A trust account may be opened at a reputable bank which is under the control of the managers of the fund.
3. A special purpose company may be created as a condition of the extractive sector concession, governed by the principles outlined above.
4. An Environmental Protection Fund (as is the case in Zambia) or similar government fund can be created for decommissioning purposes.

There are important policy trade-offs in each one of these choices. Option 1 creates a very neutral and legally sound structure, but restricts the degree of flexibility; it can leave the trustees of the fund with a challenge when there are insufficient funds due to underestimation of costs. Option 2 is more flexible, but carries less legal certainty that the funds will be used for their stated purpose. Option 3 has a greater level of flexibility, and would enable the operator to be more directly involved; it however runs the risk

Deduction may not be claimed before the decommissioning work takes place.

Allocation to cover future removal costs is often not deductible.

Common tax relief in the oil and gas industry.

8.9 Special considerations for the mining sector

International accounting practices for restoration and rehabilitation costs in the mining industry vary from no recognition of a liability to full recognition. There is no specific International Accounting Standard dealing with the costs of closing a mine, but this issue, and the recognition of provisions in general, is being addressed by International Exposure Draft E59 - Provisions, Contingent Liabilities and Contingent Assets and a number of very similar national exposure drafts.

According to PricewaterhouseCoopers the most commonly used methods in the mining industry are:

Expense as incurred
Incremental method

In the mining sector, a key element in achieving comprehensive mine closure is to have in place adequate financial resources available to the mine, or the government, on closure to ensure that it can be carried out successfully. Financial instruments are particularly important in the developing countries where, quite often, there is a lack of legal framework addressing these issues.

According to mining experts approximately 30 per cent of the developing countries studied have included provisions for bonding. The tax implications of the provision systems in the mining industry in developing countries, needs to be further investigated.

A further challenge may come from costs incurred that are strictly speaking not for decommissioning, e.g. for repurposing of fields which is not uncommon for the mining sector. It is possible that in some cases good planning can lead to continued use of an extractive sector project for some completely different purpose, e.g. the conversion of open pit mines into a lake with fisheries or tourism potential. The technical argument here will be whether such expenditure is of a revenue nature (i.e for decommissioning) or a capital cost (development of a new facility), especially if the same owner, or a related company, continues to operate the facility. It is recommended that a flexible approach be taken, and the tax treatment decided in a manner that balances the need to encourage more efficient use of sites with the need to raise revenue.

9.2.3 Multiple operator cases /combined fields

Another complex area can be that of multiple operators who are partners in a single field. One operator may have other income from the jurisdiction while the other operator may only have one project. The first operator may wish to see ongoing deduction of decommissioning costs, while the latter would probably prefer an accrued provision. Again, a flexible approach, based on the accurate estimation of costs, and controls to ensure that both operators will perform their obligations, can enable policymakers to create a win–win situation that will allow both operators to make the most efficient use of their resources.

A related challenge can be multiple operators who manage contiguous fields, but utilize common facilities such as pipelines. The problem can be particularly aggravated if the fields in question have different expected lives, as the operator in the field with the lower expected life have less time to provide for its share of decommissioning costs of common facilities, and more importantly, will probably be absent from the country when the pipeline needs to be decommissioned. In such cases, the decommissioning plan needs to be agreed with both (or multiple) parties, respective shares allocated, and a funding mechanism with oversight from both parties is probably the best solution.

9.3 VAT/GST and services tax issues around decommissioning

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issues regarding work done on offshore platforms. Such subcontractors should be subject to the normal regime for withholding taxes and VAT.

10 Mechanisms to Resolve Issues/ Dispute Resolution

1. Consultation/hearing process
2. Independent 3rd party expert
3. International judge (JDA/Border line disputes)

11 Annex: Taxation of Environmental and Restoration Costs in Zambia

1.1 Introduction

This write up provides insight on the tax treatment of Environmental Restoration and Rehabilitation costs in Zambia. It also provides a historical background to the current legislation.

1.2 Type of mining in Zambia

The mining industry is an economic and social backbone of Zambia. The major minerals produced include copper, cobalt, nickel, manganese, coal, emeralds, amethyst, beryl, lime stone, talc and uranium (though uranium is currently just been stock piled). The major by-products from copper extraction are gold, platinum, palladium, selenium and silver.

The main mining methods include open pit, underground, solvent extraction and electro wining.

1.3 Casestudy – environment restoration costs

Mining companies in Zambia like in most countries are required under the Mines and Minerals Development Act to undertake environmental impact assessment studies and make binding commitments through an environmental management plan to conserve and protect natural resources during and after cessation of mining activities.

Whilst this legislation had always been in place under the Mines and Minerals Act since 1995, Zambia had until April 2006 no specific provisions in the Income Tax Act (ITA) that dealt with the environmental restoration and rehabilitation costs. Nonetheless the ITA had two general provisions that dealt with Environmental restoration expenses, namely:

1- General Deduction Provision

(i) Section 29(1)(a) of the ITA is the general deduction provision and provides that:

"in ascertaining business gains or profits in any charge year, there shall be deducted the losses and expenditure, other than of a capital nature incurred in that year wholly and exclusively for the purposes of the business;"

The above quoted provision requires that the environmental restoration and rehabilitation costs should:

(a) not be of a capital nature; and

b) be incurred in the relevant year to qualify for tax deduction.

Whilst the decision to determine whether the outgoing is revenue or capital in nature is a debatable one, environmental restoration and rehabilitation costs are of a capital nature as decided by tax cases and as such this provision effectively barred deduction of Environmental expenses. Accordingly, then one had to look at the other leg of deductions in the ITA applicable to mining companies, which deals with capital expenditure deductions.

2- Capital Expenditure Deduction

First Schedule to the Income Tax Act (Further Classification of Income)

Paragraph 9

Amounts refunded to any person carrying on mining operations pursuant to paragraph (a) of subsection 3 of section one hundred and twenty two of the Mines and Minerals Act shall be deemed to be income in the year that the refund is made.

Fifth Schedule to the Income Tax Act (Mining expenditure deductions)

Paragraph 22(4)

A deduction shall be allowed in ascertaining gains or profits of a person involved in mining operations in respect of actual costs incurred by way of restoration and rehabilitation works or amounts paid into the Environmental Protection Fund pursuant to section one hundred and twenty of the Mines and Minerals Development Act, 2008.