I. NOTE BY THE SECRETARIAT

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treatment of subcontractors. Further, the coverage is restricted to taxation issues, and other contractual issues related to service providers, such as local content, training, skill development of partner NOCs, etc. issues are not covered in the chapter.

XX.1.2. Terminology used

In this chapter:

- "Subcontractor" means a service provider to a resource company, limited to the type of services discussed in this chapter.
- "Resource company" means the concession owner/license holder to the resource extracted.
- "Resource state" means the jurisdiction who granted the extraction license.
- "VAT" means a broad-based tax on final consumption that allows for the deduction of tax paid on inputs (referred to as GST in some jurisdictions).

XX.2. The role of subcontractors in the extractive sector

XX.2.1. Value chain in extractive sector and position of service providers/subcontractors

The upstream sector involves the search and recovery of crude oil, other hydrocarbons and minerals, as well as their commercial recovery and production. Until the 1960s, it was common practice for the oil majors to run operations completely in-house; they also conducted in-depth research into drilling, completion and production technologies. Starting from the 1980s, these were licensed to oilfield services companies, since functions such as drilling yielded low margins and diverted the attention of resource companies. During the 1990s, there was increased exploration in remote and offshore locations as well as more challenging subsurface conditions in the extractive sector. These conditions allowed the services providers to move up the value chain to be innovators. Moving into the 21st century, accelerating commodity prices and demand, at least until the global financial crisis of 2008, created conditions where it was viable to experiment with new technologies in areas like high-pressure hydraulic fracturing, deep sea mining, etc. Major service providers had the size and scale to invest in such area and develop proprietary technology solutions.

Support operations have increasingly been outsourced to specialized companies with in-depth e wa Tj EMC

may be used for mine construction. And certain other services are common between hydrocarbons and minerals extraction such as logistics and at end of life/asset retirement stages.

The roles of subcontractors are broken down in XX.3 below by the resource extraction stages set out in Chapter 2.

XX.2.2. Nature of business and location of services provided

Although the subcontracting sector is dominated by a few large companies, there are thousands of small, private companies and individual contractors. Most of the companies are small in size; e.g. 94% of oilfield services companies had fewer than 100 employees in 2014. On the other hand, the top five largest publicly traded companies generated one-third of total revenue from oilfield services in 2014.

In the early stages of resource extraction (see Chapter 1), the services of these smaller businesses are predominantly performed outside of the resource state. In the latter stages, these services are predominantly performed in the resource state. However, with the introduction of new technologies, many services are increasingly being provided remotely. Most of these smaller businesses operate in multiple jurisdictions at any given time and may perform a service from multiple jurisdictions s [illegible]

when the service provider has actually earned the consideration, and treatment of income that arises where the project starts to generate revenue.

XX.3.2. Exploration stage

Exploration processes in the extractives sector require specialized technical skills which are not typically retained by the resource company. This phase involves geological, geophysical, and geochemical analysis using sophisticated software and technologies, such as advanced 3D seismic technology. Subcontractors often conduct geological mapping and surveys, seismic capture and sampling, analysis, test drilling or excavation services, etc. The resource company may also outsource local staffing, logistics support and other ancillary services.

Other resource companies may have some in-house capabilities for this phase or may have related group service companies that have special competencies in these areas.

The tax issues in this stage are likely to be around characterization of the payments where services are performed, and payments made may differ; some services will be performed outside the resource state and payment will be from the resource state.

XX.3.3 Feasibility and design stage

To evaluate whether the project should commence, subcontractors provide economic and technical analysis, mine planning, design of exploitation platforms, etc. Again, a significant part of the services would necessarily be performed outside the resource state, while consideration paid would have to come from the resource company

XX.3.4. Development

Production drilling mine construction and building of the necessary facilities can be conducted onshore or offshore. Typical services include the engineering and construction of platforms, conveyer lines, pipelines, and storage tanks. Mining companies are likely to retain s (s)1 (ig)12

equipment; the aircraft in question is based in neighbouring Country B and does not land in Country A; it merely flies over the EEZ to capture the data. The data is then sent to Company Q, which is tax resident in Country E for the analysis work.

In consideration of the payment to be made by Y to P, P covenants to perform and complete the service in conformity in all respects with the provisions of the contract and Y will to pay P in consideration of the performance of the service the compensations at the time(s) and in the manner prescribed by the contract. All contract rates of compensation and any other price(s) agreed upon

charges shall be paid for any additional serviceable quantity of equipment the company has in its inventory.

Daily rental rates shall apply from the date the equipment is required on a company site as per the hire notice and shall cease when a site off hire notice is issued by a site representative. The daily rental shall be additional to the monthly rental. The rental rates (both monthly and daily) quoted by the contractor include routine servicing, testing, inspection, normal wear and tear and supply of normal related items. A charge showing the maximum running hours for each piece of equipment and the actual hours as at the date the equipment arrives at the company's area basses shall be supplied with the equipment.
The contractor shall provide an equipment identification card (route card) with the equipment. The card will accompany the equipment despatched to the rig site to enable the responsible staff to log in actual data such as equipment identifications number, specifications, actual and maximum running hours and proof of purchase with acquisition date.

All inspection will be performed by a company approved subcontractor at the company's area bases at the company's cost. All repair charges for equipment shall be pro-rated based on the actual running hours compared to the manufacturer recommended running hours between service with a maximum charge of 100% if reaching or extending beyond the recommended running hours.

The contractor shall promptly mobilise and maintain the agreed maximum quantity of equipment. The contractor shall consign and maintain at their responsibility and cost adequate quantity (stock) of spares for all types and sizes of equipment for the company's base operations to allow for timely repair of the equipment. Timely replenishment of all requested consigned spares will be provided by the contractor at their responsibility and cost. The contractor will be held responsible to investigate any failure or abnormal damage to the equipment requested by the company, on a case by case basis, and the contractor shall promptly report in detail to the company.

Contract VI – Provision of drilling services utilizing a MODU

Company P, President in Country B agrees to provide a MODU (Mobile Offshore Drilling Unit) to Company X and Company Y, both incorporated as single purpose entities in Country A (resource state), engaged in the exploration phase in contiguous offshore blocks in Country A. Company X and Company Y are respectively owned by separate IOCs with cross ownership. The value of the MODU is estimated as $ 150 million, and the daily charter rate is agreed to be $ 600,000. In order to reduce downtime during the travel from Country B to Country A, it is agreed that the drilling activity will be performed consecutively at Company Y and Company Z blocks, and the two client companies will share equally the charter costs during mobilization (travel to Country A) and demobilization (travel back from Country A).

XX.4.4. Complex tax issues – Split contracts

The first challenging area is the need to address mismatches and challenges around split contracts. These are more likely to be encountered in the initial stages of the life cycle of extractives projects, i.e. up to XX3.3. above. Contracts for services to be provided might be split up into an onshore (i.e. within the resource state) and an offshore component (outside the resource state). There can

- Reasonably accurate valuation for tax purposes of movable assets that are transferred into and out of a taxing jurisdiction.
- Treatment of Customs Duty and VAT/GST on imports, especially where equipment is scrapped or sold.
- Establishing approximately accurate depreciation schedules for specialised equipment used in extractive exploration and production, which might not be (p)-3ed

XX.4.9. Payments for services delivered in special economic zones or special areas

Should this include bonded areas for consumables?

XX.4.10. Payments for services rendered by

be impacted by the characterization of the income in question, and how taxing powers for that income are allocated in the relevant treaty, see further below.

The charge to WHT on income flows of services providers and subcontractors, as moderated by an applicable treaty, will be heavily influenced by whether the treaty is based on, and more importantly, interpreted in line with the UNMC and its Commentary. Unlike the OECD Model, the UNMC deems royalties and technical service fees "to arise in a Contracting State when the payer is a resident of that State", at Art. 12(5)/12A (5) UNMC. This is further extended to such payments by the PE of a non-resident where the obligation to make such payments is incurred in connection with the activities of the PE. It is of course later clarified that Art. 12/12A would not apply where the income is attributable to the PE of a non-resident (where Arts. 5 and 7 would apply); see further XX.6 below.

Detailed guidance on the scope of the charge is available in the Commentary to the UNMC; Para 13 of the commentary on Art. 12A is of particular importance here, which clarifies that the scope of the charge contemplated is wider than the services delivered performed in the resource state. The opposite view is also discussed in Para 16 of the same discussion, where the minority view was to rely on a taxing nexus based on the extent of services actually performed in the resource state. Accordingly, there are likely to be disputes on allocation of taxing rights in split contracts even where the relevant treaty allocated taxing rights to the resource state through definitions based on Arts. 12/12A (5) UNMC.

Where the relevant treaty has a more restrictive definition of royalties, lease payments and technical service fees, WHT treatment becomes more challenging. Some typical problem areas are

XX.5.2. Characterization of income for the purposes of WHT charge

The discussion above shows that the charge to WHT, imposed by domestic law and moderated by an applicable treaty, will be significantly impacted by the language of the treaty and its interpretation. This will of course crucially depend on the degree to which the resource state has been able to achieve a broad enough definition in the royalties article, or whether there is a technical service fees article (as is the case in some treaties). A treaty which defined royalties using language from Art 12(3) at the UN Model Convention 2017 (UNMC) "…..or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience." rather than the more restrictive language of the OECD Model Convention, would of course be more advantageous from the point of view of the resource state. A treaty that covered payments for technical services, especially those based on Art. 12A UNMC that allocated taxing rights to the source state on such income would give the resource state scope to charge WHT on the payments.

The practical reality is that most treaties are based on compromises reached between the treaty partners, and most current treaties will not use the language of Art. 12A UNMC. The key issue is thus characterization of payment flows to service providers and subcontractors as royalties or technical service fees subject to the allocation of tax rights through WHT in the treaty. The question is whether the payments are covered by the "…… for information concerning industrial, commercial or scientific experience" definition in the equivalent of UNMC Art 12(3) in the treaty, assuming that such

this is quite difficult to distinguish. Also, as most of the treaties currently in force would have been negotiated before the inclusion of Art. 12A into the UNMC, it is likely that the only treaty provision available will be that equivalent to Art. 12. It will therefore be necessary to have a pragmatic approach in income characterization, based first on the domestic law of the resource state and then applicable treaty provisions, with reference to the UNMC Commentary. Countries may wish to take an approach under which the UNMC Commentary on Art. 12A is considered separately where the relevant treaty has an article covering technical service fees. Where it does not, the guidance in the commentary on UNMC Art. 12 is used, of course where the relevant language of "…… for information concerning industrial, commercial or scientific experience".

A further compromise approach could be that of adopting the narrower interpretation of technical service fees discussed at Art. 24 of the commentary to UNMC Art. 12A. This would allow taxation by resource state (from which the payment is made) in cases where the services are not performed in the resource state; however, the fees must be for services that are directly related to the enjoyment of property for which a royalty as defined in the equivalent to Art. 12 is paid. This would of course limit the ability of a resource state to apply WHT only to services associated with intellectual property.

Contract II: Withholding tax

Payment for the services performed in could be subject to withholding tax under domestic tax law if the company's income is not taxed as a permanent establishment in?
The domestic withholding tax rates are often modified by tax treaties which could place a maximum percentage on the amount of tax that can be withheld by the source state on royalties and technical service fees. The article of the US India tax treaty dealing with royalties and fees for included services restricts withholding tax to a maximum of 15%.

Under the provisions of the treaty "fees for included services" are payments for rendering any technical or consultancy services (including through the provision of services of technical or other personnel) if such services: (a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which the payment is received; or (b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

Contract III: Withholding Tax

There is no withholding tax on the services when payments are made from the United Arab Emirates. The client may be situated in a free zone (Jebel Ali) and the free zone regulations should be checked for any tax concessions affecting the supplier. If compensation is on a rental basis this could involve payments being categorized as leasing or rental payments, however there is no withholding tax on these payments in the UAE.

Although the UAE has concluded a large number of double taxation agreements these cannot create a liability, but they specify the taxing rights of the contracting states in relation to each category of income.

Contract IV: Withholding Tax

The withholding tax position on fees for technical services depends on the local legislation as modified by the provisions of a relevant double tax treaty. Some countries may provide for withholding tax on service fees paid abroad. A double tax treaty may set out a maximum withholding tax rate that can be charged by the source country on technical service fees. This could be included in the treaty under the Royalties article or in a separate article of the treaty. The treaty would also provide for relief from double taxation.

Contract V: Withholding Tax

Withholding tax is imposed in Oman at 10% on dividend payments; interest; royalties; payments for services, management fees; consideration for the use of or right to use computer software; and consideration for research and development. It is likely that withholding tax would apply to payments under this contract for leasing and related services.

XX.5.3. Tax treatment of leased assets and of lease payments

Services are often provided using leased assets, which might take a number of different contractual approaches, which are of course defined by the circumstances of a particular project and the business relationships between the parties (e.g. - term, pricing arrangements). It is possible to consider the following structures:

- The service provider itself leases the equipment, using a finance lease structure, and uses the leased equipment in the resource state to provide services. Leaving aside the question whether the equipment creates/contributes to creating a PE (see below XX.5.6.), the issue is if WHT applies to payments to the lessor, assuming the service provider makes them from within the resource state point.
- The service provider leases the equipment to the resource company from a different jurisdiction, usually as an operating lease, and possibly has subcontractors providing staff as well as the service providers on teams to help operate the equipment. Again, the application of WHT to lease payments, and combination of services and leasing of equipment must be considered.

The language of UNMC Art. 12, includes payments for the “use of industrial, commercial or scientific equipment” within the scope of royalties; thus, an applicable treaty that uses the same language would allow a charge to WHT if prescribed in domestic law. The commentary to UNMC Art. 12, at Para 13.2. clarifies the scope of “industrial, commercial or scientific equipment” and it would seem that the equipment mentioned above would be within the scope of that definition.

However, there could be difficulties in establishing whether the payments made were actually for use of equipment. Para 13.3. of the commentary to UNMC Art. 12 discusses the application of the Article to cases of finance leases and points out that some of these transactions might fall under other provisions of a treaty, including both the business profits and other income articles. Thus,

application of WHT payments to lease transactions need to be analysed by reference to the lease terms (see list of criteria at Para 13.3. of the Art. 12 commentary).

There can also be additional complications on leased assets where associated services are included, as the lease element and the services element must be separated. As in the case of the second structure mentioned above, there may be additional services from contractors that are integral to the contractual arrangement. However, if the service provider receives a gross fee combining both lease and service elements, it faces the challenge of deducting WHT when paying its own subcontractors. This results in double taxation and adds an unnecessary deadweight cost to the project. And while resource companies and service providers can try to mitigate this by the resource company paying the subcontractors direct after deduction of WHT, at times this might not be viable given contractual obligations, work warranties or to maintain business confidentiality.

XX.5.4. Computation issues

WHT poses a significant cost to service providers and subcontractors, who may in turn require contracts to be "grossed up" for WHT. This can, in turn, increase the possibilities of duplication of charge, as the grossed up amounts (which contractually are payable by the resource company to the service provider) are then liable to WHT, resulting on a "tax on tax". To mitigate this, some countries have included a provision in their domestic law to avoid a WHT on the gross up of taxes, which resolves both the deadweight cost issue and the complications of computation. In the absence of such a measure, however, the gross up may need to be done iteratively to ensure that the service provider is able to receive the full amount that it has contracted for.

A further longer-term complication could be the impact of contractual terms such as "holds harmless" clauses, that require that the service provider will assume the tax obligations arising from a contract after the work has concluded. This can arise in particular with smaller subcontractors deployed by the service provider (e.g., in the circumstances mentioned in the second structure in XX.5.3. as direct subcontractors of the resource company. Where, e.g. the subcontractor is later considered on examination by the tax authority to [illegible] taxation to

Service providers will often use ships, and to a lesser extent, aircraft as part of their contracts with resource companies. Such equipment will include e.g. time or voyage charters of ships to transport products such as coal, iron ore, crude oil, refined petroleum products and LNG; some of these vessels will include specialized equipment to maintain the products during transport (e.g. LNG carriers). They will also use

might charters on bareboat basis, especially for ancillary or specialized craft, i.e. when the vessel is provided without crew and the service provider adds its own crew to deliver the service. These services would not fall within the scope of "…….operated in international traffic". The next question is to consider if they fall within the concept of "operation of boats in inland waterways".

XX.5.6. Order of charge/WHT procedures

WHT on royalties and fees for technical services are usually taxable in a resource state of whether the service provider or subcontractor has a permanent establishment (PE) (m)-4.5 (e)4.4 (n)-4.5 (t)-4.4 (a)-4.5 (b)-4.4 (l)-4.5 (i)-4.4 (s)-4.5 (h)-4.4 (m)-4.5 (e)-4.4 (n)-4.5 (t)-4.4 (( )-4.5 (P)-4.4 (E)-4.5 (2)-4.4 (m)-4.5 (e)-4.4 (4)-4.5 (T)-4.4 (J)-4.5 (-)-4.4 (0)-4.5 (.)-4.4 (0)-4.5 (0)-4.4 (4)-4.5 (T)-4.4 (J)-4.5 (-)-4.4 (0)-4.5 (.)-4.4 (0)-4.5 (0)-4.4 (6)-4.5 (8

measure and would of course only apply to cases where the service provider or subcontractor was actively contesting PE treatment.

XX.5.7. WHT administration issues for payers of income to service providers

XX.5.8. Relief for WHT in residence state

Relief for WHT suffered in the source state would need to be achieved in the residence state of the service provider or subcontractor within the rules, possibly based on Arts. 23A/23B of the UNMC, as negotiated in an applicable treaty, or possibly under unilateral relief rules of the residence state. Also, while double tax relief may be available in the residence state for foreign tax paid there may be limits on the extent to which the tax could be offset against the tax liability in the residence state For example, where a country allows a credit for foreign tax paid this may often only be offset up to the amount of the tax liability on tw0 (oTd [(s)-2.1 (1)-2 (i)-2 (a15 Td [(s)1 s)0.9 (t th)-as1-10 (onl)-4(a (o)2 (n (t)]TJ(f)-1J(f)-71 (o t)-204 Tc -0.016 T (uf)3 (-4 (rm)-2 (as)-2g (i)-n1.15 Td [1 (o

Examination of question of establishing PE through performance of services including consultancy services, - applicable tests, split services, purely remote services such as seismic analysis, management and operation services performed on service client site, connected services under treaties signed under old model. (Some provisions of bilateral tax treaties follow the wording of the UN model treaty in relation to the creation of a permanent establishment by the furnishing of services),

Contract III: Permanent Establishment

Non-

XX.6.7. PE issues around split contracts

(attribution of service by nonresidents to PEs of group companies, services split between related parties, connected services attributed to different companies, digitalization of services as enabler

rated, meaning no VAT is charged on exportation and all input VAT can be deducted or should be refunded.

Contract I: Value Added Tax (VAT)

services. If “Country B output VAT” is charged, Company X will be allowed to deduct this VAT paid as an “Country B input VAT: Whether “Country B output VAT” is charged will depend on whetherthe service is deemed to be consumed in Country B, or outside of Country B – is the offshore oil platform located within the VAT jurisdiction of Country B.

Contract V: VAT

Lease agreements are generally treated as consecutive supplies for VAT purposes. Cash flow issues may, however, arise where an invoice is created indicating the consideration to be paid over the entire lease period, but actual payment is only made throughout the leasehold period. Most jurisdictions require that VAT be paid on the earliest of invoice or payment, for the amount indicated on the invoice or received as payment. It is therefore generally advised that countries should have special rules regarding the time of supply of large capital purchases. The preferred rule in this regard is that VAT becomes payable as payment is received, not on the invoice basis.

Contract VI: VAT

It is important to understand that VAT is charged on the supply of goods and services, as opposed to goods and services. This means that a single good or service may be supplied multiple times, concurrently. In this contract it should be determined what portion of the good and services are supplied to which recipient. Hereafter, separate invoices should be generated to reflect the consideration for these separate supplies. Whether these supplies are charged with output VAT, zero-rated, or not charged with VAT depends on the place of supply and consumption of these goods and services, as discussed in the previous contracts.

XX.7.3. Use of special regimes

Supplies by a party with a temporary place of supply, Voluntary VAT registration in a jurisdiction/reclaiming inputs, use of credit mechanisms for resource companies to encourage registration, Inter State movement of capital equipment and its treatment for GST/VAT purposes specifically in EU and countries like India.

XX.7.4. VAT issues for contractors in decommissioning/rectification

(no client output VAT to be relieved, refunds mechanisms)

XX.7.5. Customs duty and import VAT issues

temporaryadmission issues such as high value exploration equipment brought in temporarily, classification issues (e.g. is a MODU a vessel or not), Application of charges and use of depreciated value for re-export, multiple users of same equipment, tracking of assets subject to incentives, valuation of assets, establishing benchmark values, ringfencing of assets, rules for second hand equipment, rules on related party asset transfers, project area limitations for incentives).

provides for income from employment to be taxable in the state where the employee is present and performing the work. This principle applies to salaries, wages and benefits in kind and should apply without any regard to where the income is paid to the employee. The exception from the general rule is where the employee is present in the other state for not more than 183 days in a tax year. The other conditions are that the salary is paid by an employer who is not resident in the state where the employee is working, and that the remuneration is not borne by a permanent establishment of the employer in that other state.

This means that only those staff working abroad for short periods could remain exempt from tax in the destination country. This exemption allows employers to send employees to work for short periods in other states without the employees becoming liable to tax in those other jurisdictions. However, if staff are going to live and work in the foreign country for longer terms or will be working for a foreign employer the treaty provisions will not prevent them becoming resident in the foreign country. Accordingly, the exemption, provided for by many treaties will often not be applicable to employees working abroad.

Some additional factors also need to be taken into account in determining residence and taxability. E.g. in one country, individuals with a presence of 182 days or more in an income year or a presence of 90 days or more in an income year and of 365 days or more during the preceding 4 income years are deemed residents for tax purposes. Since most successful extractive projects are long term undertakings, it is possible that employees who may consider themselves non-residents may be considered residents under domestic law due to their frequent travel and presence in the country over a period of time. The UNMC Commentary, which essentially repeats the guidance in the Commentary to the OECD Model, provides detailed guidance on this treatment. The difference in tax treatment between residents and non-residents can be significant. A non-resident may be taxable on a gross basis through a WHT, while a resident will usually be able to benefit from allowances, rebates, credits and exemptions available under domestic law.

The fourth issue to consider is the quantification of the income that is subject to tax as employment income. The contract of employment may allocate different values for work done by the employee in the resource state, and work done either in the home state or a third country. There may also be the possibility of a split contract, where the employee is paid a salary for his work in the resource state but may also be paid a proportion of salary to defray costs such as maintaining a home, pay education costs, etc. in the residence state. There may also be a risk that a split contract has been entered into, under which the employee receives a proportion of their employment related income in a foreign bank account, without any separate duties or rationale cited as the reason of such a split. The challenges for a developing country tax administration in these cases lie in identifying the nature of a split contract to test whether there is an actual rationale for such a split or simply a crude form of tax evasion.

These challenges could be significantly mitigated by guidance on available thresholds for establishing tax residence, declaration procedures to show actual total compensation paid and what duties such compensation is intended to compensate and treatment of short-term employment contracts.

XX.8.5. Treaty benefits in deemed profit jurisdictions.

Satisfaction of clause 15(2)(c) of UNMC remuneration borne by the deemed pmhpaoy (m)2mn

lifting the “veil of incorporation”, i.e. looking through the corporate structure to the underlying individual owner of the service company. If this is available, and there is the equivalent of Art. 14 UNMC in the relevant treaty, the resource state may be able to impose tax if the individual is present in the country for a period or periods aggregating at least 183 days in any twelve-month period commencing or ending in the fiscal year concerned, even if there is no fixed base.

resource company will be performing the VAT computation and compliance function and making the payment on their behalf. This would approximate a reverse charge in economic terms, even though the subcontractor in question may be providing services in the resource state. A simplified compliance procedure which allows the acquirer of services from providers within the resource state to meet VAT compliance requirements of providers could facilitate compliance for small subcontractors.

XX.9.6. Administrative and compliance issues

XX.10.3. Contractor treatment in Production Sharing Contracts

(E.g. there may be provisions affecting subcontractor tax in PSCs and in some cases a rate of withholding tax on the subcontractor or specific treatment for VAT may be set out in the agreement.)

XX.10.4. Role of NOCs in “tax paid” PSC structures

Status of subcontractors.

XX.10.5. Application of fiscal stability clauses to subcontractors

XX.10.6. Other policy areas

(Local content, skills dev and training, coordination between ministries)

XX.10.7. Dispute resolution

Subcontractor has been in dispute that could not be resolved and has left the project hanging. Dispute did not get resolved and the knock-on impact can be great.

XX.10.8. Models for good practices

(Use of ATAF Models)?

Deemed profit arrangements? Option?

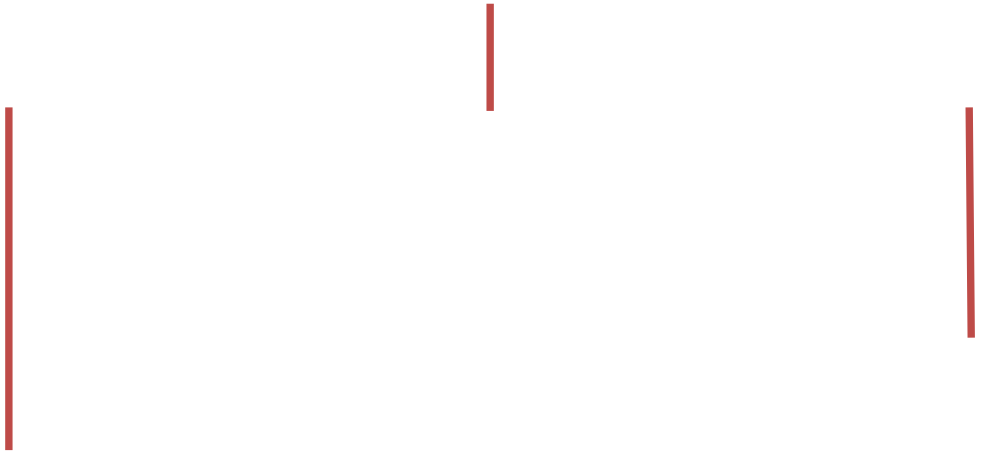
(Annex 2) ProductionSharing Agreements (PSC)

Features and tax implications in the Oil&Gas (O&G) sector

DRAFT FOR DISCUSSION

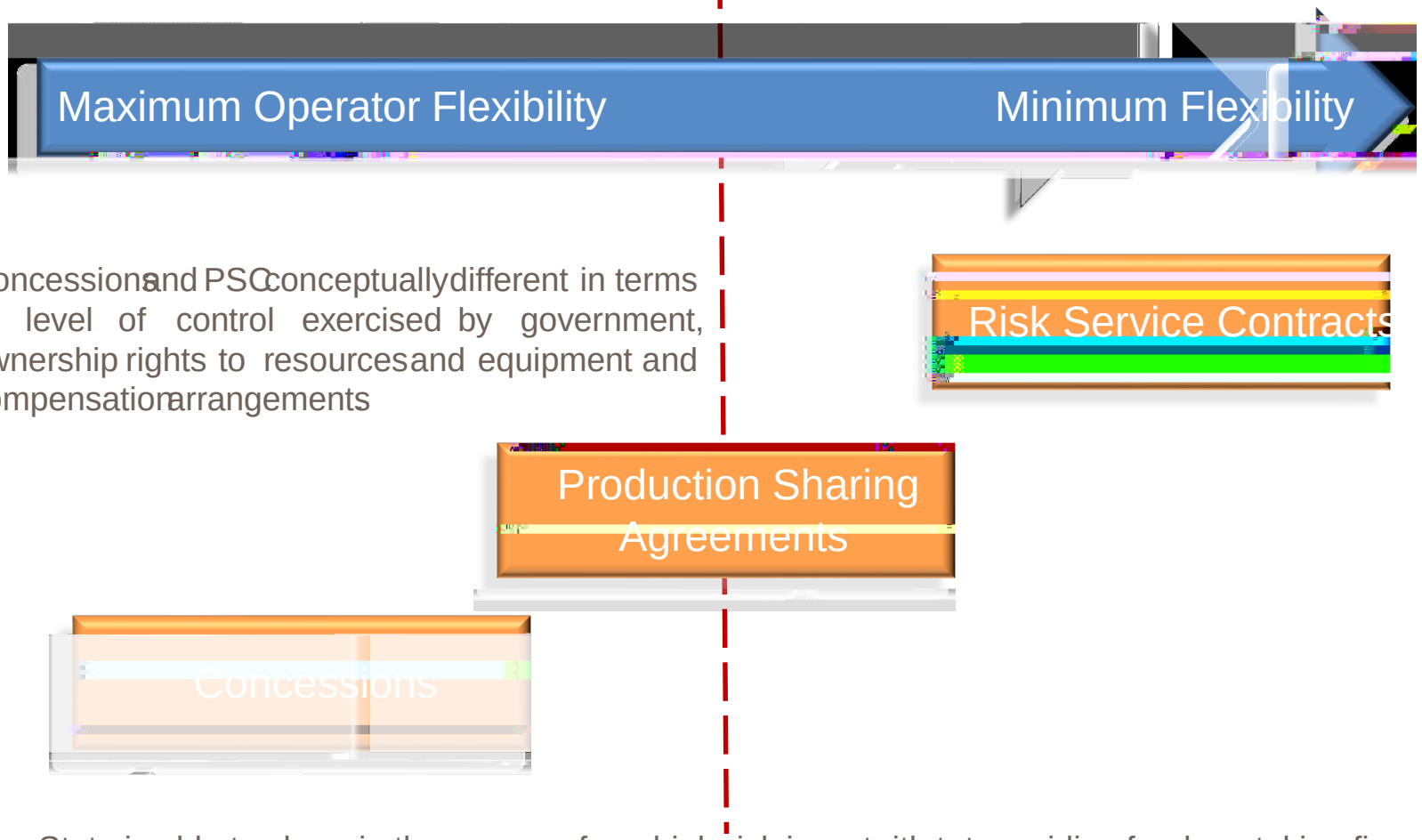
United Nations, April 2019

Fiscal System Taxonomy



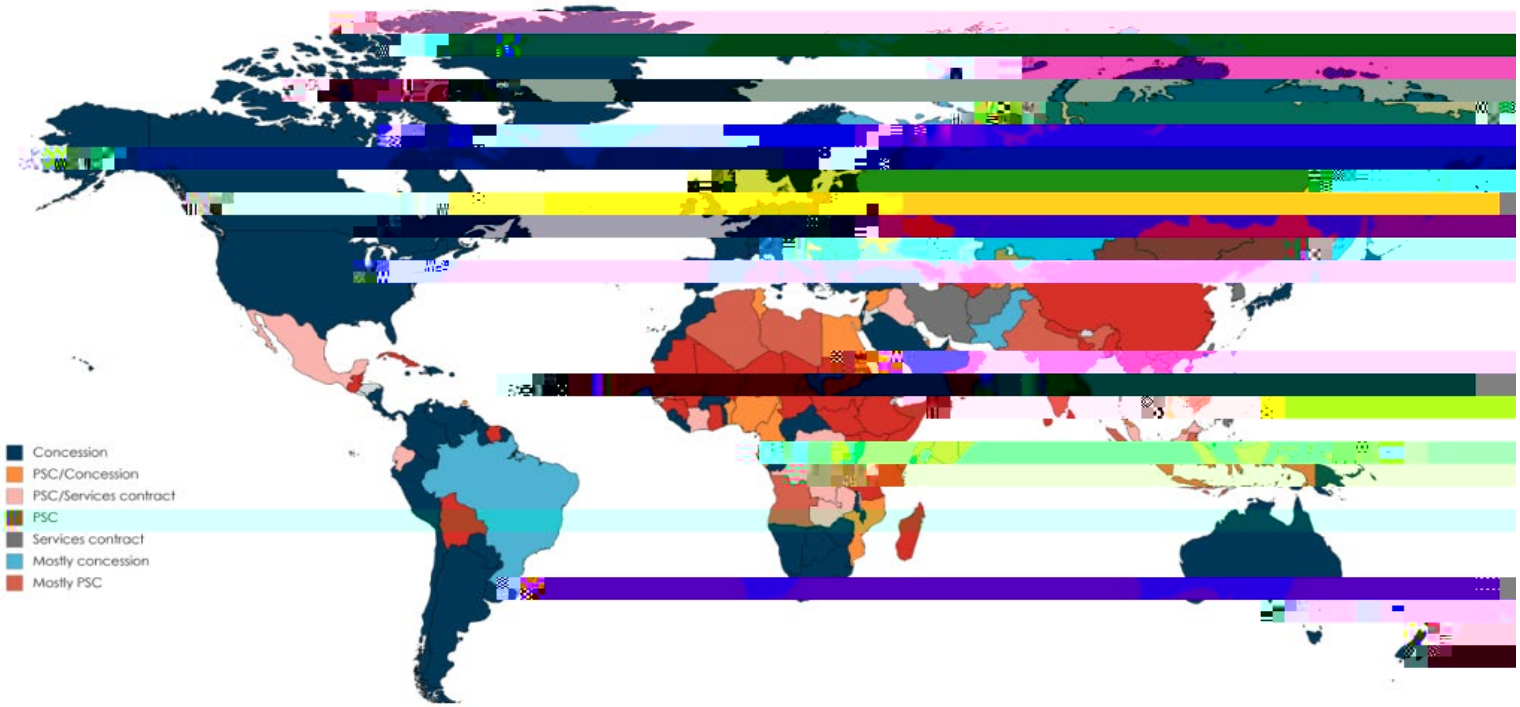
Fiscal System Taxonomy

The issue of ownership is the fundamental distinction between the concessionary and contractual systems Under concessionary system, the contractor has title to O&G produced. Under PSC, government retains title to resources



In PSC the State is able to share in the revenue from high risk investments without providing funds or taking financial risks

Fiscal System Taxonomy



Origin of PSC

- First PSC was signed in August 1966 with Permina, the former Indonesian

- Broader or macro policy objectives from a government perspective are

Parties to a PSC

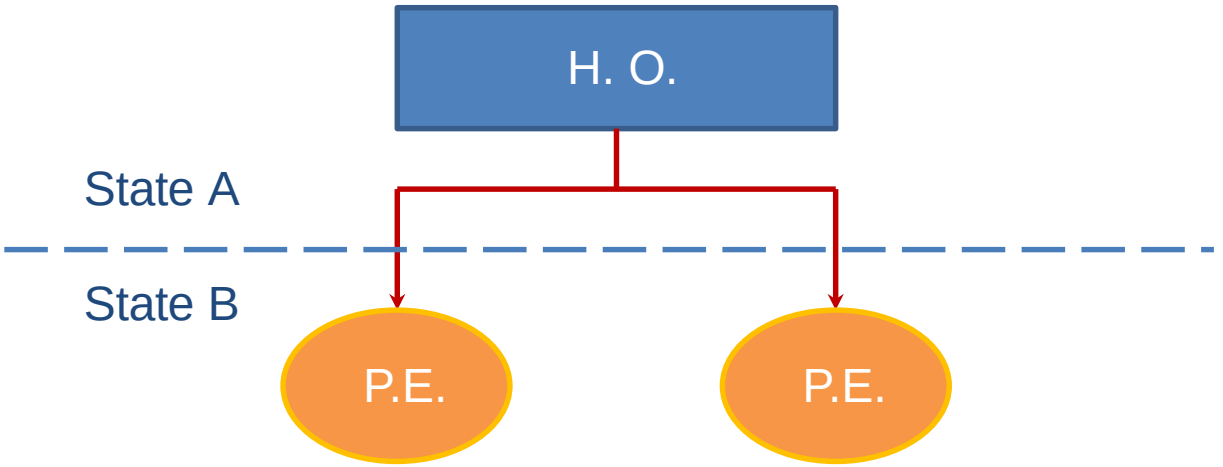
- Contractual agreements are concluded between one or more oil and gas companies (contractors) and a State entity, which could be:
  - A government department
  - A Ministry
  - A government agency
  - National oil and gas company

- Coordination between government departments on the policy with regard to the hydrocarbon industry is required.
- Ministry of Finance and Tax administration representation is important when a PSC is negotiated and the contract is finalised

- Ring fencing means a limitation on consolidation of income and deductions for tax purposes across different activities, or different projects, undertaken by the same taxpayer
- Ring-fencing

Relation with Permanent Establishments

- A PE per PSC
- In order to have a single place of business both geographical and commercial coherence is required.
- The geographical and commercial coherence is normally defined by each of the contractual areas where oil and gas companies perform their activities through different joint ventures within a country.
- Under domestic law of certain countries, it is not allowed that one entity signs more than one PSC.
- Legal title by means of a Production Sharing Contract over a contractual area (geographic element) which is normally governed by several partners under a JOA managed through a consortium (commercial element) leads to a PE. Accordingly, when a contractor has entitlements to more than one contractual area in a country, it is considered that it has more than one PE within that country.



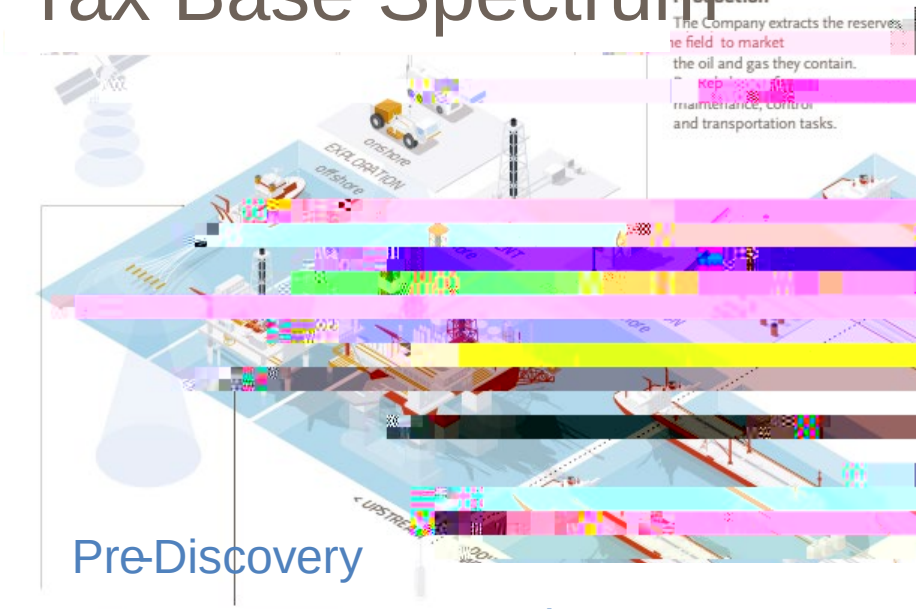
Joint Ventures

- Joint Ventures
  - Joint Ventures are a common mode of doing business in the

Forms of Production Sharing

Production Sharing	
Daily Rate of Production (DROP)	Government share of profit petroleum increases with the daily rate of production from the field. Weaknesses are that field size is often a poor proxy for profitability and the mechanism is not progressive with respect to oil prices or costs Attempts have been made to blend this with a scale of prices
Cumulative production from project	Government share of profit petroleum as total cumulative production increases – again an inaccurate proxy for the contractor's rate of return. Such schemes are becoming rarer.
'R-Factor'	Government's profit share increases with the ratio of contractor's cumulative revenues to contractor's cumulative costs (the 'R factor')

Tax Base Spectrum



‰PSC

Pre-Discovery

Post- Discovery

- Signature Bonus

Gross Revenue
- Production Bonus
- Royalties

Profit Oil Split

Net Revenue
- Income Tax
- Windfall Profit Tax

E&P costs (Recoverable Cost)

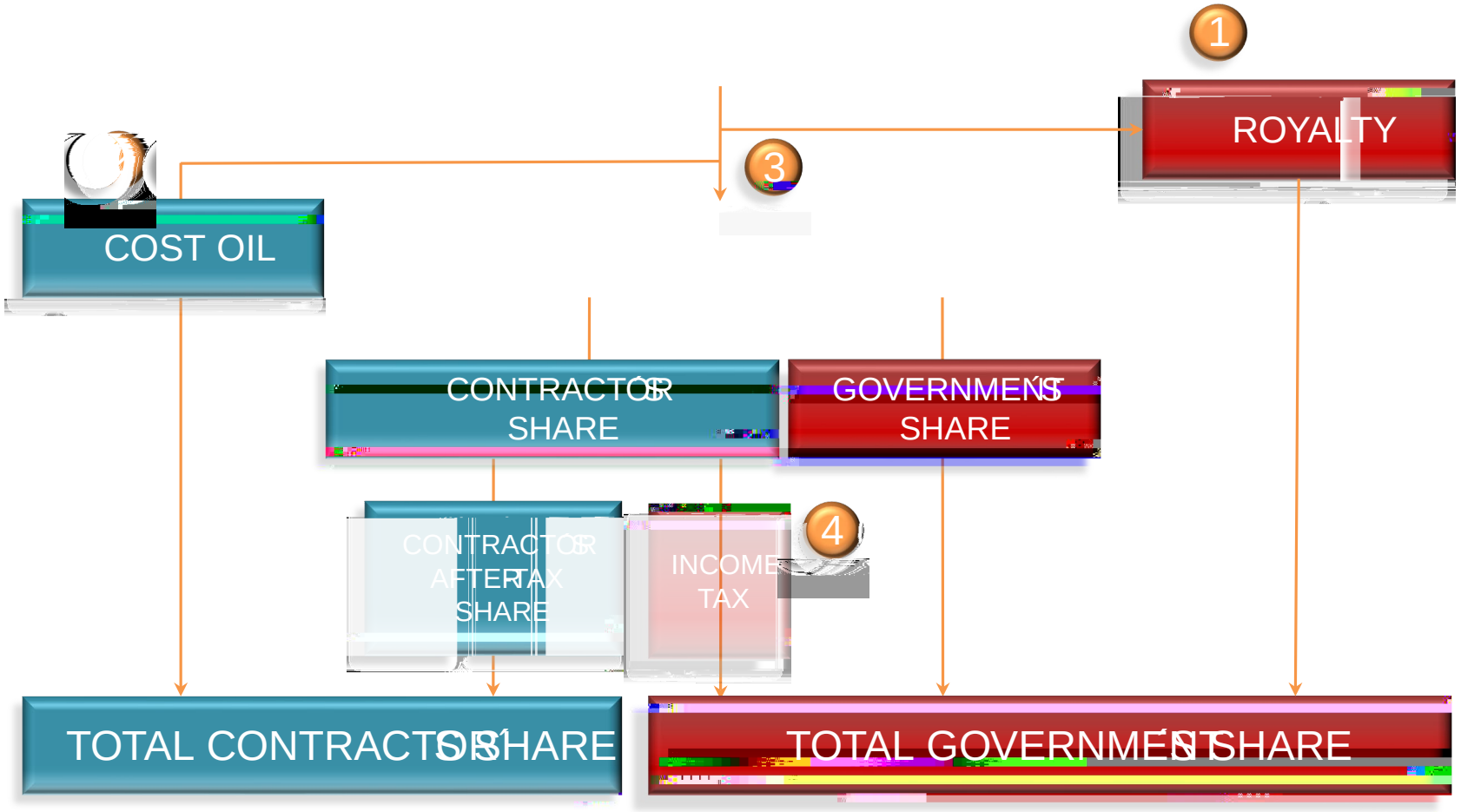
Cost Recovery (Limited)

Operating Costs

Abandonment Costs

Government Participation

PSC Revenue Flow



Cost Oil: share of total production, which can be retained by the contractor to recover costs incurred, normally subject to a maximum amount (cost oil limit).

Profit Oil: share of remaining oil after cost recovery Profit oil is divided between

Work Commitments I

- Minimum work

Development Bonus

Payment made at a certain point in time during the life of the petroleum contract. May occur at the time that a commercial discovery is declared, at the time that petroleum plattha

Bonus II

EXAMPLE EXCERPT FROM THE KURDISTAN

Rentals

- Fixed payment made on an annual basis, normally at the beginning of the calendar year or contract year
  - May take on different forms: it could be a fixed amount for the contract, or fixed amount per square km. of operations land, the "object value" or a negotiated amount.
  - The basis for charging may vary between exploration/exploitation phase and/or onshore and offshore.
  - It may be payable depending on the territorial zone in which operations are carried out (e.g. Algeria)
- Recoverable cost / deductible
- Provides government regular income and encourages voluntary relinquishment of acreage
- Issues regarding the delimitation of the "area":
  - EXAMPLE: INDONESIA LAND AND BUILDING TAX (PBB)
    - 0,5% of a "deemed" tax base (ranges from 20% -0.(PBB(B)22(3a)-4(4)2(a)3h2.2(7)10T1(P)5.[(<7W4(B)3(B)D6(2)2[(m)]38400

Royalties

‰

Sliding Scale Royalties I

- Used to escalate the royalty

Sliding Scale Royalties II

EXAMPLE – ALGERIA: The rate is determined in each contract. However, the law has fixed a minimum rate per area[1]:

Production (BOE) / Area	A	B	C	D
0-20,000 BOE/day	5.5%	8.0%	11.0%	12.5%
20,001-50,000 BOE/day	10.5%	13.0%	16.0%	20.%
50,001-100,000 BOE/day	15.5%	18.0%	20.0%	23.0%
> 100,000 BOE/day	12.0%	14.5%	17.0%	20.0%

EXAMPLE – THAILAND II REGIME: If the royalty is paid in cash, the following sliding scale applies[1]:

Monthly sales volume	Rate %
0-60,000 barrels	5.00
60,001-150,000 barrels	6.25
150,001-300,000 barrels	10.00
300,001-600,000 barrels	12.50
> 600,000 barrels	15.00

A deep-sea, offshore exploration block (deeper than 200 meters) is subject to only 70% of the royalty that would otherwise be payable according to the table.

(1) EY O&G tax guide 2018: https://www .ey.com/Publication/vwLUAssets/ey-global-oil-and-gas-tax-guide/$FILE/ey-global-oil-and-gas-tax-guide.pdf

Profit Sharing I

- PSCs include a fiscal tool that defines some of the production as "Profit Oil/Gas" and shares it between the State and Contractor.
- COST OIL
  - Oil retained by the contractor to recover the costs of exploration, development and production. Most PSCs limit the amount of cost oil that can be retained in a given accounting period (the effect is that the State receives its share of profit as soon as production.
  - Costs that are not recovered are carried forward and recovered later; most PSCs allow virtually unlimited carry forward. It is another avenue available to the government to ensure early revenue (considered less regressive than royalties)
  - The PSC specifies which costs are eligible for cost recovery. Usually, these include unrecovered costs carried from previous years, operating expenditures (OPEX), capital expenditures (CAPEX) and abandonment costs
  - Expenses not eligible for cost recovery

Interaction with other Tax Instruments

- PSCs and royalties payable
  a) Could form part of cost oil and be recovered by the contractor.
  b) Could be payable by the contractor before profit oil is allocated
  c) Could be payable by the State from its share of profit oil.
- PSCs and corporate income tax
  a) The tax liabili[illegible]

Annex 3: Production Sharing Agreements (PSC)

1. Fiscal System Taxonomy

A. Concessionary and Contractual regimes

- Tax/Royalty
- Production Sharing Agreements
- Service contracts

B. Choice between Tax/Royalty and PSC

2. Production Sharing Contracts

A. Origin of PSC

B. Design of a PSC fiscal System

- Parties to a PSC
- Ring Fencing
- Relation with Permanent Establishments
-

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(Annex 4)
TaxTreatment of Financial Transaction in the Extractive Industries

Financing in the Oil&Gas (O&G) sector

DRAFT FOR DISCUSSION

United Nations, April 2019

Traditional Sources of Financing

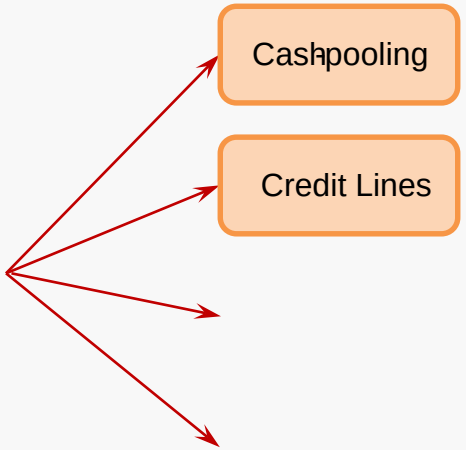
‰ A company should make a judicious decision regarding how the funds shall be raised, since:

ƒ Increase use of Equity results in the dilution of ow0 Tc 0 12 86 i[1i.4 (y)n Td [(P)0.((s)tig)10 (ena(Td [(o)116.7 7.75 >>BDC

Option	Benefits	Challenges
Equity	ƒ Allows full control. ƒ Requires strong balance sheet. ƒ Long term. ƒ No cost to external parties. ƒ Returns invested in business/returned to shareholders.	ƒ Difficult to raise. ƒ Dilution problems. ƒ Expensive – cost of capital
Debt (Loans)	ƒ Flexible source of short-term debt. ƒ Flexibility in reduction and repayment.	ƒ Capacity constrained except for large, preferred borrowers or short-term borrowers. ƒ High cost of funds make heavily bank funded projects virtually unprofitable.
Mezzanine Finance	ƒ Provides alternative hybrid of debt/equity. ƒ Flexibility in reduction and repayment structures	ƒ Security required in most cases. ƒ Complex in structuring. ƒ Complex disclosure and due diligence requirements.

Capital/Debt

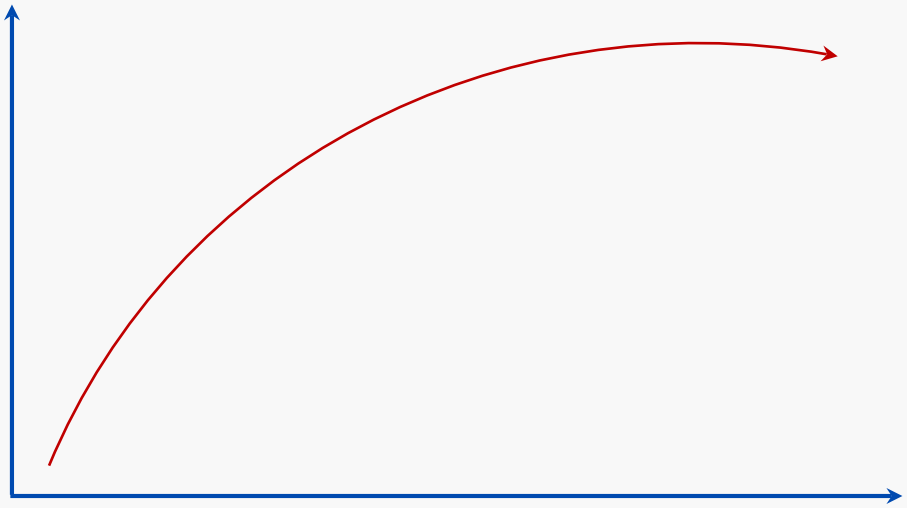
- The financing decision involves two sources from where the funds can be raised (i) using a company's own money, such as share capital, retained earnings or (ii) borrowing funds from the outside in the form of debenture, loan, bond, etc. The objective of financial decision is to maintain an optimum capital structure, i.e. a proper mix of debt and equity.



CAPITAL Shareholder contributions	ƒ Pure Capital ƒ Shareholdeŕs loan
DEBT External Financing	ƒ International/Local Banks ƒ Syndicate ƒ Club Deal ƒ Multilateral Supranational Organisms ƒ International Finance Corporation (IFC) ƒ European Investment Bank (EIB)E 0 Tf 0.00-8591 Tf 0 Tc 27p104d i(t)v6(e)6a(n)3. 0 Td [(3 ([(3 (c ƒ

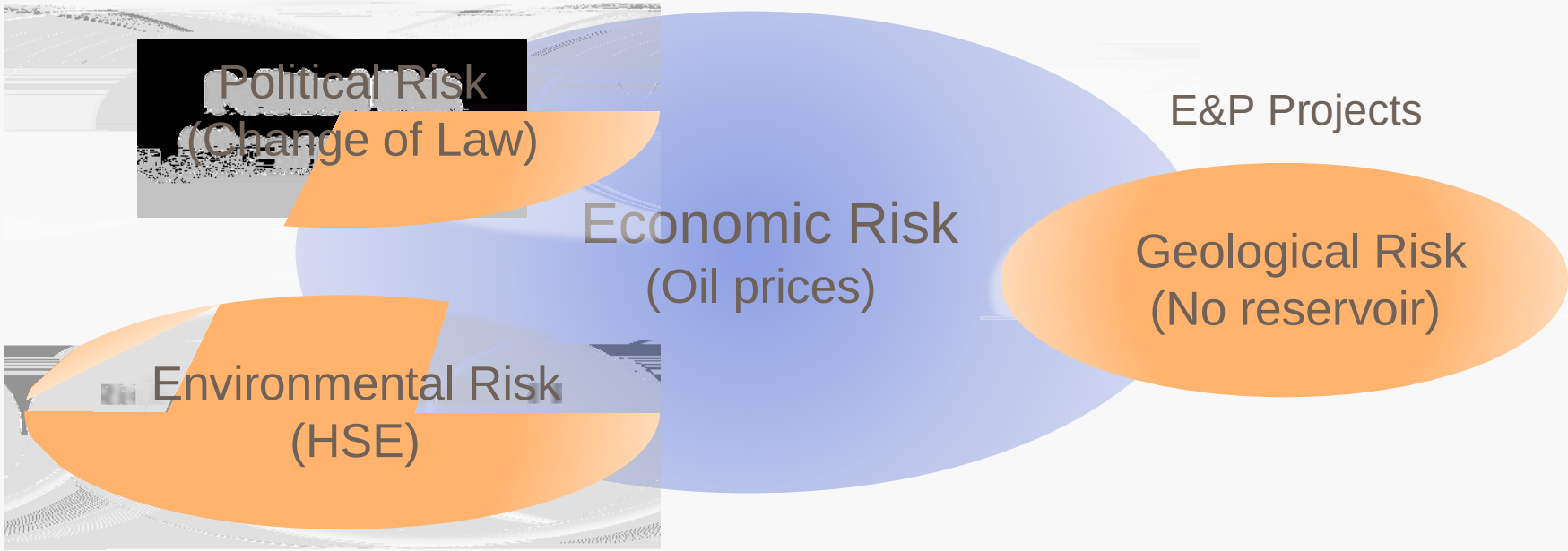
Financing in the Extractive Industry

- Characterized by two factors since its inception: an extraordinary high degree of risk and a constant hunger for capital [1].
- Each investment is different from a Risk-Return standpoint

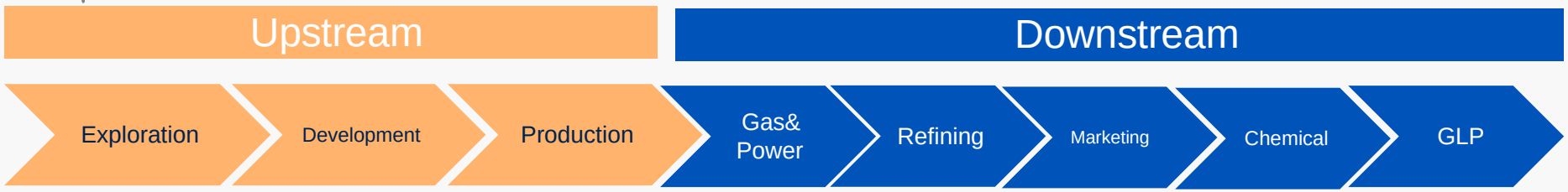


Financing in the Extractive Industry

- All O&G projects have risks, E&P has more than others:



Supply Chain Financing in the Extractive Industry



Upstream

Risky, low predictability and capital intensive

- Exploration is equity financed.
  - Usually unable to borrow from external sources due to the high risk/capital involved
- Farm-in/farm-outs:
  - Exploration companies may bring in a new partner in exchange for a future spending commitment. The owner of a working interest (the farmor) seeks finance by exchanging a portion of its working interests to another party (the farmee) in return for the farmee's performance of some agreed upon action. Eg.: the farmee may agree to undertake exploration of a property or drill a well(s). In return the farmor agrees to exchange a portion of the working interest.
- External financing
  - When production begins, companies may seek external funding, including structuring finance

Downstream

Stable and long-term cash flow generation

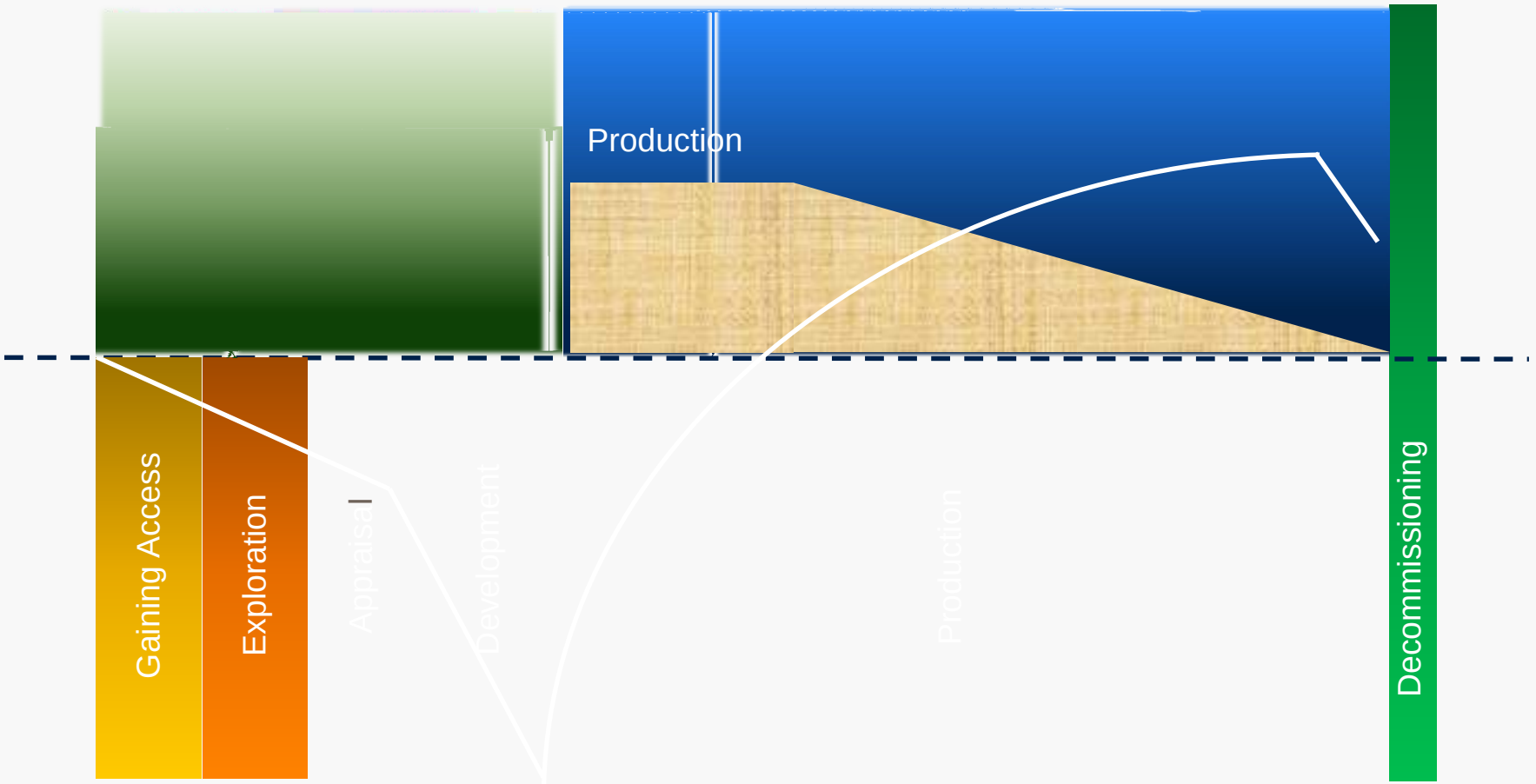
- Project Finance
- ECA's,
- Multilaterals
- Project Bonds

Shared Contracts

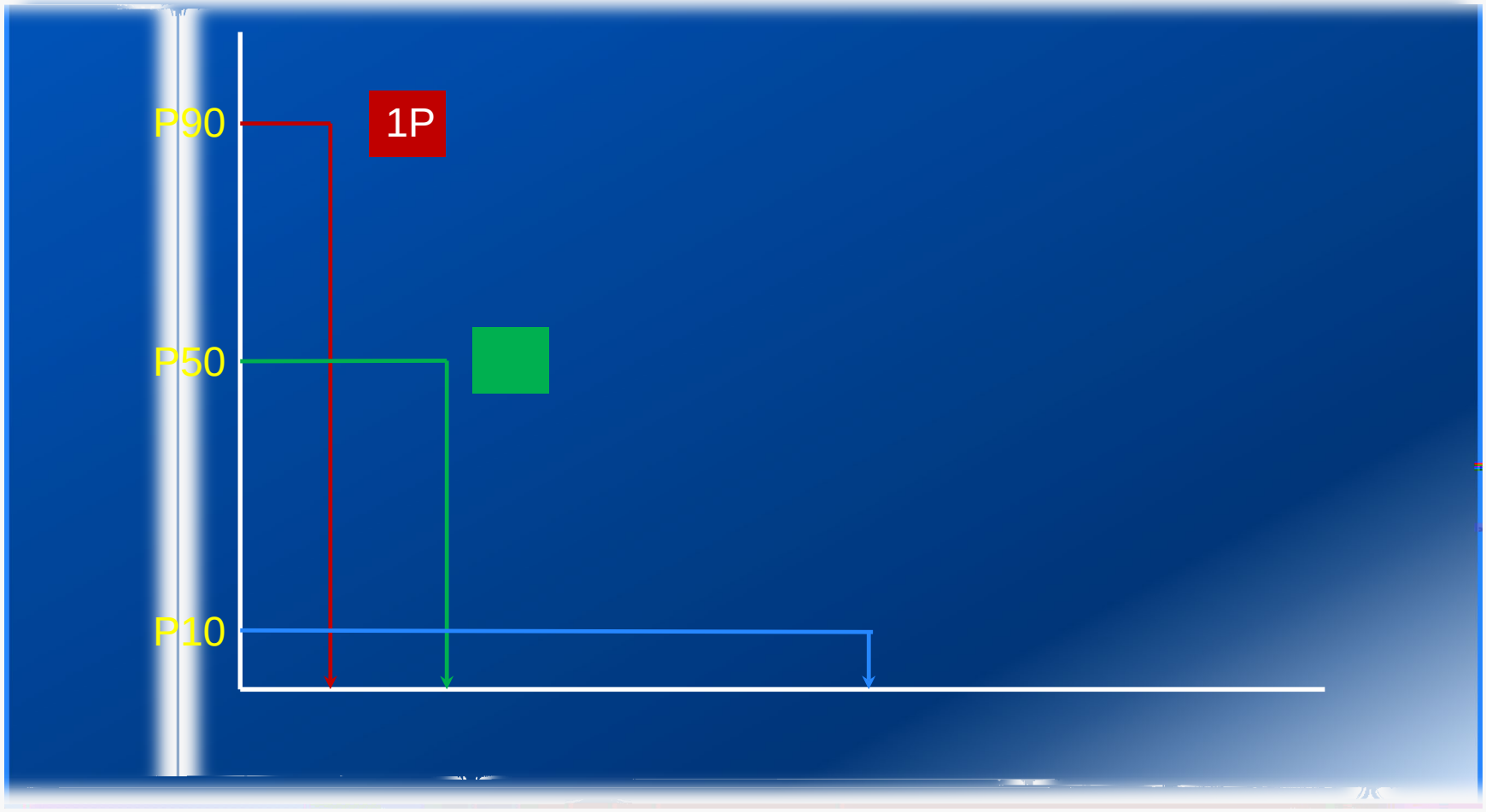
- Typically two or more companies come together to fund the execution of a contract
- Joint developments mitigates the risk of lost contracts
- Usually requires structuring from the parties involved to avoid conflicts

Fieldlife cycle:cummulativecashflow

- Banksonly lend againstprovenreservesor (sometimes)probablebut not possible



Reserve Booking Categories



Alternative Sources of Financing

Financing Tax issues

- Debt is cheaper than Equity because lenders are willing to accept a lower return (for their lower risk) than investors and interest is tax deductible, whereas dividends to shareholders are not.

	Benefit of Leverage on Investor´s Return		
		Low Leverage	High Leverage
	Project cost	1000	1000
(a)	Debt	300	800
(b)	Equity	700	200
(c)	Revenue from Project	100	100
(d)	Interest rate on debt	5%	7%
(e)	Interest payable	-15	-56
(f)	Profit	85	44
	Return on Equity	12%	22%

- In the example above, if the tax rate is 30%, the after-tax profit in the low leverage case is 60 (85*70%), whereas in the high-leverage case is 31 (44*70%).

Guarantees

Guarantee Charges			
	Concept	Bank	Intra-group
Financial fee	Financial cost derived from the bank's legal requirement to held a reserve for the issuance of guarantees	9 Financial guarantors disclose the s75.721 (r (n)0.78 (a)- Td []-11.09491w 1.887 0 0 n.3	

Parent Guarantees

- MNE groups have the advantage of accessing to other group companies resources (e.g.: funding). In particular, less capable entities can improve their creditworthiness if a related company provides them with a guarantee. In this respect, within a group, guarantees are provided to unrelated third parties to secure the obligations of other group companies (pledges to fulfill their obligations in case they fail to do so themselves).
- Types of parent guarantees
  - Financial Guarantees: a promise to take responsibility for another company's financial obligation (principal sum plus interest thereon) if that company cannot meet its obligation.
  - Non-financial Guarantees (performance guarantee) also known as a contract bond, provide security for non-financial obligations issued to one party as a guarantee against the failure of the other party to meet obligations in the contract (other than obligations in respect of payments, indebtedness or other monetary obligations of any kind) as agreed between the parties. In particular, in respect of the delivery of goods or the completion of a project or of guaranteeing the quality of an outcome. Performance guarantees are normally used in sectors where long-term and large contracts prevail, such as the natural resources or construction. As such, it involves three parties:
    - the client – an unrelated entity seeking to buy goods or services from the group;
    - the contractor – a group company that is primarily involved in

- The OECD 2017 TP Guidelines consider that intra-group performance guarantees should be paid for when:
  - The guarantor performs a deliberate concerted action (mere passive association is

- Issuance of bonds
  - O&G companies may issue bonds or securities in the market to fund their projects through intra-group loans A parent company guarantee is provided in favour of the affiliate (sometimes in a third country) that operates as the issuer of record issue eco he

Annex 5: Financial Transactions in the Extractive Industries

1. Introduction
   A. Capital Investment needs & decisions
      - Investments Risks
      - Change of law risks
      - Quasi-political risks
   B. Investment Returns
2. Traditional Sources of Financing
   A. Capital
   B. Debt
3. Financing in the Extractive Industry
   A. Supply Change Financing
      - Upstream
      - Downstream
   B. Farm-in/Farm-outs
   C. Alternative Sources of Financing in the IE
      - Royalty contract
      - Streaming Contract (prepayment Contract)
      - Exploration Finance Facility
      - Supplier financing
4. Financing Tax issues
   A. Limitation of deductible interest
   B. Guarantees
      - Guarantees charges
      - Financial guarantees
      - Non-financial guarantees
   C. Hedging

Annex 6: General outline for a Chapter on TAX INCENTIVES in the Handbook

Chapter Overview:

Many developing countries use "tax incentives" in the hope of attracting additional domestic and foreign investment. Their effectiveness is often disputed, not least in relation to the extractive sector, which involves location specific resources. Nonetheless, governments may

- Once a country has selected a “type” of fiscal regime it is possible to identify measures that are more generous than the regime and hence constitute a tax incentive.”

- For the purpose of this chapter, and considering the variety of extractive industry fiscal regimes, it is not possible to identify all possible deviations. What may appear in isolation as an incentive, may in fact be the natural corollary of a restriction elsewhere in the regime (for example, the immediate expensing of capital expenditure may appear to be an incentive, when in fact it is the natural outcome of adopting a cash flow tax approach and denying relief for borrowing costs). Instead, the chapter will discuss the pros and cons of typical incentives commonly used in extractives that are defined with respect to the main fiscal regimes previously outlined.

b. Tax incentives: the legal framework

- It is common for countries to have numerous sources of law governing extractive industry revenue collection. In addition to the income tax code, which may include a schedule on extractive industry taxation, there may be fiscal provisions in the mining and oil and gas laws, as well as in investment agreements, investment promotions laws, and double tax treaties. Each source of law may contain tax incentives. In this section we will outline the various sources of law that may contain tax incentives, and the interaction between them.

2. Design and Use of Tax Incentives

a. Driving principles

- Clear policy objective – Often incentives are given without clear objectives in mind, or an understanding of the possible alternative ways, other than through tax, to achieve the same aim. Where governments do decide to use tax incentives, they should be linked to sp ( )]TJ 0/f 0.002 Tcl D28 (o)2 (b)2 (je)6 (c)6

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b(centives

resources required to administer it. Some incentives are easier to administer than others, e.g. building on information already available.

- Government revenue losses. Incentives may result in unintended revenue losses for government. This section will highlight the potential for inefficiencies arising from investors changing their behaviour in response to an incentive to maximise the tax benefit in ways that were not envisaged by government.
- Alignment with other government policies. Even if the objective of a specific incentive is clear, if not in line with or in absence of aligned government policy, this may not be helpful.

x We will also highlight the various tools available to governments to determine whether incentives are necessary (i.e. financial modelling) and efficient and effective (i.e. cost benefit analysis, and tax expenditure analysis). We will stress that financial modelling take into account the full extent of the benere2p (cen)53 11

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4.8.2 7UDQVIHU SULFLQJ FKDOOHQJHV OLPLWHG WH[W WR
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4.9.1 6WDWXV DQG FKDUDFWHUL]DWLRQ RI VHUYLFH SURYLGHUV
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4.9.2 7D[LVVXHV UHODWHG WR LQGLYLGXDO VHUYLFH FRPS
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WKH UHOHYDQW HPSOR\HU LQ VLWXDWLRQV RI H J K
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LQGHSHQGHQW VXEFRQWUDFWRUV WR HPSOR\HG 0D
DQDO\VLV 3RVVLEOH DSSURDFKHV WR VROXWLR
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4.9.3 7D[WUHDW\ LVVXHV $SSOLFDWLRQ RI GRPHVWLF OD
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(b) 2SSRUWXQLWLHV IRU UHYLHZ VXQVHW FODXVHV

&DVH VWXGLHV

7KH SULQFLSOHV RXWOLQHG DERYH ZLOO EH XVHG DV LQFHQWLYHV 7KH DLP LV WR LOOXVWUDWH ZKDW ZRU WUDGH SROLF\ QHHG WR FRQVLGHU 3RWHQWLDO DFFHOHUDWHG GHSUHFLDWLRQ WD[KROLGD\V LPSRU IRU FRQWULEXWLRQV WR HQYLURQPHQWDO IXQGV

7RROV

7KLV VHFWLRQ ZLOO KLJKOLJKW WKH YDULRXV WRRO ZKHWKHU LQFHQWLYHV DU\ L H ILQDQFLDO PRGHOOLQ FRVW EHQHILW DQDO\VLV DQG WD[H[SHQGLWXUH DQ

&KDSWHU$GPLQLVWUDWLRQ RI 7D[,QFHQWLYHV

(a) 7UDQVSDUHQF\ LV QHFHVVDU\ WR HQVXUH HIILFLHQW DYRLG WKH SRVVLELOLW\ RI SROLWLFDO FRUUXSWL LQFHQWLYHV 7KLV VHFWLRQ ZLOO H[SORUH QWKLHYRSV

(i) &RQWUDFW GLVFORVXUH

(ii) &OHDU PHDVXUDEOH SROLF\ REMHFWLYHV

(b) 0RQLWRULQJ RI LQFHQWLYHV

(i) 5HJXODU FDOFXODWLRQ DQG UHSRUWLQJ RI EXUHDY LQFHQWLYHV

(ii) $XGLWLQJ RI LQFHQWLYHV QRW IURP DQ EXW FLHQ VLPSO\ ZKHWKHU WKH LQFHQWLYHV DUH SURSHUO\

&KDSWHU&RQFOXVLRQ

([SODQDWLRQ DQG LOOXVWUDWLYH H[DPSOHV R

F R X Q W U \ Z K H U H W K H X Q G H U O \ L Q J D V V H W V O L H V D V
U H V L G H Q W L D O F R X Q

& K D S W H U 6 S H F L D O C O H V

, Q W H U D F W L R Q ± E H W Z H H Q W K H 3 H U P D Q H Q W 5 H V L G H Q W
2 W K H U V "

> W R F K H F N I R U 0 L Q L Q J V S H F L D O D V S H F W V @

& K D S W H U 7 U D Q V D F W L R Q V D Q G W U D Q V L W L R Q D O P H Q W

6 W D P S G X W L H V

9 $ 7 V D O H V W D [W U H D W P H Q W

) R U D Q V D F W L R Q L W V H O I

) R U X U X H F R V W V F D U U \

,QIRUPDWLRQ DQG GDWD FROOHFWLRQ SRZHUV WR F
GHOD\V DSURYDOV RI DXGLW LQIRUPDWLRQ

5LVN EDVHG DSSURDFK WR LQWHUQDO DXGLW SODQQLQJ

3RVW DXGLW UHSRUWLQJ FODXVH RQ GLVFORVXUH RI DXG
VKDUH SHUIRUPDQFH RI OLVWHG 01(V DQG WKH NQRFN

&KDSWHU 5OH RI -RLQW 9HQWXUH SDUWQHUV2LQW UHQG
*DV LQGXVWU\

&KDSWHU $XGLW RI 3URGXFWLRQ 6KDULQJ $UUDQJHPH