

Capital Gains Issues in the Extractive Industries

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PRACTITIONERS' CORNER

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In this article, the author discusses some of the issues for a country to consider in determining whether, and to what extent, it should tax natural resource-related capital gains. Before making this determination, each country should consider the tax policy it wishes to adopt regarding capital gains for taxpayers across all industries, not just the extractive sector.

When a taxpayer transfers all or a portion of a capital asset acquired for use in its business (for example, property, a plant, equipment, or license rights), general income taxation rules in many countries treat some or all of the gain as taxable. Countries that impose capital gains taxes also often treat some transfers as nontaxable, the most common being some business reorganization transactions. In designing their tax regimes, countries therefore should determine whether to tax capital gains in the first place and, if so, whether some transactions should be exempt from the tax or whether the tax should be deferred for some period.

When a transfer occurs outside the taxing country that has the effect of transferring the ownership of assets within the country, such as via the sale of shares in a company that owns the in-country assets (or the

shares of a subsidiary that owns such assets), a further question arises regarding the ability, and desire, of the country to impose its capital gains tax on such indirect asset transfers. The taxation of these so-called indirect transfers is hotly debated. Without going in depth on the complex issues raised in seeking to tax indirect transfers, this article will address some considerations a country may weigh in determining whether, and how, to tax indirect transfers related to natural resource transactions.

General Principles for All Industries

As noted, the first principle should be to identify and decide if any, and if so which, transactions will give rise to capital gains taxation as a general matter.

If transactions are generally taxable, it is likely that a country will want to identify and consider the scope of any exceptions to taxation, such as restructuring or reorganization transactions or gains arising from currency valuation changes in which no gain in real terms exists.¹ Whenever a transaction is treated as taxable, a fundamental correlative rule is that the tax basis of the assets in the purchaser's hands should be the price it pays for those assets. This can be described as resulting in a stepped-up basis if the assets are sold at a gain.²

If a transaction within a country is considered taxable, the country must further decide if it should tax a

¹For example, the commentaries to the U.N. model state that while "capital gains which are due to depreciation of the national currency are covered . . . [i]t is, of course, left to each State to decide whether or not such gains should be taxed." (See para. 11 in the commentaries on article 13 of the U.N. model double taxation convention.)

²The difference in treatment of a taxable versus nontaxable transaction is generally a timing issue for a country. Assume

(Footnote continued on next page.)

transaction occurring outside the country, which has the effect of indirectly transferring ownership of the in-country assets.

In making the determination on taxation of indirect transfers, a country should identify the pros and cons of asserting taxation on that out-of-country event (for example, time value benefits, public perception, compliance costs, administrative burden issues, and the resources required to maintain and implement such a tax regime).

If a country does decide to tax indirect transfers, it should:

- only tax those transfers that, if done within the country, would be taxable; and
- provide a mechanism for an in-country step-up in basis to achieve symmetry between direct and indirect transfers.

Application to Extractive Industries

The general principles outlined above are equally applicable to extractive industries. Specifically for oil and gas, it is common for large projects to be conducted via joint ventures, with several participants rather than one investor. This is a typical risk- and cost-management strategy for multibillion-dollar investments. Countries seeking to maximize the potential of their resources can benefit from policies that promote the efficient addition of other partners or co-investors, including by permitting partners to join a project without triggering a tax, especially when no net cash is involved.

Interests in oil and gas projects are often transferred in ways other than an outright sale. As noted above, an investor frequently brings in other partners at various points along the development of a project. In an oil and gas farm-in transaction, a new partner may enter a project with an obligation to reimburse the existing investor for a share of its sunk costs or an agreement to bear future costs — either proportionate or disproportionate to its acquired interest. In such cases, even if some cash changes hands, it does not necessarily create an economic gain.

To illustrate:

- Assume Investor A negotiates a contract with Country X to explore for and develop an oil and

gas project. As a part of the negotiation, Country X carefully chooses a mixture of fiscal terms to provide it with a specific amount of (i) upfront revenues (for example, via bonus or other upfront payments or investment requirements), (ii) revenues based on production, irrespective of profitability (for example, via royalties based on the gross value of the production), and (iii) finally, other revenues based — and only due — upon profitability (for example, via income, excess profit or rent taxes).

- Assume that Country X calibrates its government take with the notion that investors typically calculate returns on a discounted cash flow basis, with a discount rate somewhat higher than the country's cost of funds rate.³ Under this assumption, revenues (or lower costs) earlier in the project life are worth more to the investor than to the country on a present-value basis.
- Because investors calculate required returns needed on a discounted cash flow basis, both the absolute amount of the revenues they obtain as well as the timing of their receipt affect the viability of (and the amounts they can invest in) any project. *Note: The fact that timing differences are often more valuable to investors than they are costly to countries on a present-value basis is an important tool for countries to use to their benefit.*
- Assume that after Investor A has spent \$1 million, it agrees that in return for Investor B reimbursing A for half of its spent costs plus the agreement to bear 50 percent of all future costs, Investor B will become a 50 percent partner along with A.
- It is suggested that whether this transaction occurs within Country X or via an indirect transfer outside the country, no tax should be due on the transfer of the 50 percent interest since no net cash is involved in the transaction.

Versus a second scenario:

- Now assume instead of the transaction above, Investor A simply sells a 50 percent interest in the venture to Investor B for \$5 million (that is, at a \$4.5 million gain on the 50 percent interest sold), and thereafter Investor B, as a 50 percent partner, bears 50 percent of all ongoing costs.
- Country X has a choice:

Taxpayer A has an asset with a built-in gain of \$1,000. If it continues to use that asset in its business, it will pay tax on the future income from the use of that asset (assume that future income is \$10,000). If instead A sells the asset to B, B will have an extra cost basis in the asset equal to the \$1,000 gain. B will be able to depreciate this extra cost basis over the life of the asset, so instead of earning \$10,000 of future income, it will earn \$9,000. The total income earned remains \$10,000, with \$1,000 taxed to A and \$9,000 taxed to B if a capital gains tax is imposed on A. Where A's sale to B is not taxable, the \$10,000 of income will all be taxed to B.

³ See, for example, the IMF Fiscal Analysis for Resource Industries (FARI) model assumption that an investor will do project specific economics, requiring a return to compensate for the risks of that specific project, including specific country risks as well, rather than using as its discount rate an overall enterprise weighed average cost of capital. This generally results in the investor's discount rate on a specific project being higher than the applicable country's cost of funds rate. Additional background on the FARI model is available at <https://www.imf.org/external/pubs/ft/tnm/2016/tnm1601.pdf>.

- It can tax the \$4.5 million net gain to A, gaining some income tax revenues earlier in the life of the project, while recognizing that Investor B has an additional \$4.5 million cost basis in its 50 percent share. Future tax revenues from Investor B's share will be reduced in an amount equal to the income tax paid by Investor A at the time of the transfer. This may seem an easy decision in that the government may not want to give up current revenues (the “bird in the hand”) versus waiting for future revenues (the “bird, or birds, in the bush,” as explained below).
- However, given that an upfront cost (A's tax) is generally viewed as more costly to investors than the benefit of the offset of such costs later in the project life (to Investor B), this treatment actually can make the transfer to B quite costly to the investors on a present-value basis. This friction can make it more difficult for Investor A to bring in Investor B, which may lead to inefficiencies in the development of the resource, outweighing the timing benefit to the country of the revenues it receives. Thus, Country X should weigh the “all-in” costs of this approach compared with its benefits (that is, a timing difference for receipt of revenues).
- The results of these approaches explains why, for example, a country like Norway has decided not to tax transfers, whether in country or indirectly effected.⁴

Nevertheless, it is often asserted that transfers of large-scale extractive facilities should bring an immediate return to the government, given that profits may be

⁴While capital gains from transfers of assets located on the Norwegian continental shelf are potentially taxable, in practice most asset transactions are exempt from tax under section 10 of the Petroleum Tax Act. When the requirements of that section are met, including receiving consents from the Ministry of Finance and the Ministry of Petroleum and Energy (MPE):

capital gains arising from the transfer of assets that are allocated to the petroleum tax regime are not taxable and losses non-deductible (neither when calculating ordinary petroleum tax nor special tax). Moreover, the buyer will take over the seller's tax balances (including the basis for uplift) and other tax positions and stand in the shoes of the vendor. . . .

The rationale for these rules is that the Norwegian state's tax revenues from upstream activities should be unaffected by a transfer. . . . [C]onsent from the MOF is also required for an indirect transfer such as a share deal implying a change of control. Such deals are, in practice, straightforward from a tax perspective as there are no withholding taxes regardless of where the shareholder is a resident.

Deloitte, “Oil and Gas Taxation in Norway” (2014), at 6.

seen as significantly deferred. Thus, some would argue, capital gains should be taxed.⁵

Recall, however, that if a government has carefully crafted a revenue stream consisting of near-term, intermediate, and longer-term revenues, then taxing capital gains upsets that revenue profile by accelerating the longer-term revenues from the original plan.⁶ Since investors view the cost of this acceleration as higher than the country would view the benefit, this is a net loss in present-value terms for both.

The issue is much more political than economic. The sale of the interest at a gain provides the government a chance to deviate from the original allocation of revenues that it designed. If the government wants to stay with its original revenue profile over the life of the project, it finds itself having to explain this rationale to the public. While the economic argument is compelling (that is, the government may receive more total revenues by forgoing the capital gains tax), it is nevertheless a bit more politically difficult to articulate.

So, the question remains: Should a country tax capital gains on sales of natural resource properties? This is

⁵Centre for Public Integrity, “Taxing ‘Capital Gains’ in Mozambique's Extractive Sector” (May 2014):

It is often argued that it is politically unfeasible in developing countries not to tax billion dollar sales of the right to exploit national resources. One of the very few ways that a government can extract revenue from extractive sector projects that will not generate a profit for years or even decades is to impose a tax on capital gains.

The early injection of substantial revenue from capital gains taxes is obviously very welcome. In some cases it is seen as a major victory over powerful international companies and a redress to generous tax concessions offered in the original contracts. The significance of capital gains tax payments is often not well understood. In most countries, the capital gains tax is deductible against future assessments of taxable income. This means that a capital gains tax is not an additional source of government revenue. It does enable the government to bring forward some future revenue. But it also generates additional deductions against company taxable income. Securing early revenue in advance of production delays the onset of profit based taxes (IRPC) and pushes back the date when government revenues will become significant. The resulting offset in medium-term government revenues is considered, if it is even considered at all, a small price to pay for substantial early revenue.

⁶This assumes that the government has not factored capital gains taxes into its planning regarding the timing of overall tax revenues. In other words, if a country develops an overall tax regime with capital gains taxes as an important part, and it adjusts other parts of the regime to take this into account, then it can be argued that the “acceleration” of revenues that a capital gains tax provides is a key ingredient of the overall tax system. This would seem to be more likely in a developed and diverse economy, with a relatively predictable and regular amount of revenue available from capital gains taxes (based on years of past experience). It may be less likely in a developing country, with a relatively homogenous economy in which one or two sectors provide the bulk of its income tax revenues.

a tax policy question. If a country generally taxes capital gains of other businesses, it may conclude it is appropriate to tax gains on sales of natural resource properties as well, either under its general income tax statutes or specific statutes applicable to natural resource taxation. There may be reasons, however, not to apply capital gains taxes to natural resources — given:

- their unique timelines (that is, projects that can span decades) and often large contributions to country revenues over such periods of time;
- that fiscal terms for such large projects, if designed carefully, should be calibrated to provide a balanced mix of revenues over long project lives;
- that taxing a capital gain merely accelerates tax revenues from future periods into the period of the sale transaction, providing no additional revenue but undermining the balance of the desired revenue mix (see additional comments below); and
- that gains based on volatile commodity values, which often erode thereafter, are somewhat illusory (and, without allowing for losses based on volatility, can be asymmetrical and a disincentive to investment).⁷

Finally, taxing some capital gains could unintentionally raise the overall tax and government take rate beyond competitive levels or discourage otherwise critical merger or acquisition activities. Whatever a country decides to do, it should be clearly articulated in the law to avoid uncertainties and the need for interpretation.

The Importance of Symmetry

Capital gains taxation rules are important both to the buyer and the taxpaying seller. When a seller is taxed on its gain, the buyer should take its purchase price as its beginning tax basis for measuring future income or capital gains. Unless this occurs, the structure of the tax law itself will impose double taxation, contrary to basic taxation principles. This symmetry is an important principle for in-country, direct sales of operating assets, and its impact is equally important in the case of indirect sales if a country opts to tax those sales.⁸

Symmetry can be provided either by taxing gains and allowing the buyer a stepped-up basis or not taxing

the gain to the seller, but only allowing the buyer a carryover basis (based on the seller's costs).

Symmetry Examples

Background

The importance of symmetry can be illustrated via the following fact pattern: Investor A owns and operates an oil well in Country X. Investor A is a resident of Country X and is owned by Holdco, which is a resident of Country Y.

Investor A's well is expected to generate net cash (cash revenues less cash operating or capital expenses) of \$100,000 for each of the next 10 years. For tax purposes, Investor A's well is fully depreciated and there are no other differences between net cash and taxable income during the 10-year period. Assuming a Country X tax rate of 50 percent, Investor A expects to generate after-tax net cash of \$500,000 over 10 years ($\$100,000 \times 10 = \1 million pretax net income - 50 percent tax rate = \$500,000 after-tax net income); Country X will receive \$500,000 in tax revenues over the same 10-year period.

Assume Buyer expresses interest in acquiring Investor A's well. Ignoring time value of money issues for simplification, Investor A will likely demand an after-tax sales price of approximately \$500,000, its expected after-tax cash from retaining the well. Buyer can be expected to be willing to pay a sales price that is no more than the after-tax cash that it expects to receive from the well. The tax treatment of the transaction will have a significant impact on whether the parties will be able to agree upon a price. If the tax rules of Country X allow for symmetrical treatment, there would be no tax impediment to Investor A and Buyer reaching a deal.

Symmetrical Treatment Cases

Case 1: Seller's Gain Taxed/Buyer Deducts Purchase Price. Assume for simplicity that Buyer is willing to pay \$1 million for the well. Assuming the well is expected to generate net cash of \$100,000 per year over 10 years, the Buyer's future depreciation deductions (which were not available to Investor A) will offset taxable income generated from the well. The Buyer's future net after-tax cash generated is \$1 million and, under these simplified facts, it breaks even on this investment. (See table.)

Investor A's \$1 million sale is taxable at 50 percent, but its after-tax cash of \$500,000 is what it expected to receive from continuing to own and operate the well. Finally, Country X receives the same \$500,000 in revenue that it would have received absent a sale.

Case 2: Seller's Gain Not Taxed/No Deduction for Buyer (Typical Offshore Indirect Sale). In this case, for Buyer to have a break-even investment, it would only be willing to pay \$500,000 for the well (that is, the expected after-tax cash generated from operation of the well). The Buyer essentially steps into the shoes of Investor A, taking A's tax basis (in this case, zero), and thus has the same after-tax result that Investor A would have

⁷Again, if such gains are taxed, the stepped-up basis will, over time, provide an offset. But timing is highly relevant to investor discounted cash flow returns, and further, if ongoing income is insufficient to cover the basis step-up, a portion of the gain would be taxable while the corresponding loss is not tax effected, giving rise to asymmetry and in effect, double taxation.

⁸This section is largely based upon a part of a forthcoming paper from the U.N. Committee of Experts on International Cooperation in Tax Matters titled "Note on Capital Gains Taxation and Taxation of Indirect Asset Transfers." The October 15, 2015, draft of the paper is available at http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_Attachment2_Cgt.pdf.

**Symmetrical Treatment Case 1:
Buyer's Result**

| | Cash (\$) | Tax Calculation (\$) |
|----------------|-----------|----------------------|
| Income | 1,000,000 | 1,000,000 |
| Tax deduction | — | (1,000,000) |
| Taxable income | — | 0 |
| Tax | 0 | 0 |
| After-tax cash | 1,000,000 | |

had: \$1 million of pretax cash generated from the operations less \$500,000 of tax paid, netting \$500,000 of after-tax cash. Investor A finds the \$500,000 sales price acceptable because it is not subject to tax and therefore its after-tax cash from the sale is also \$500,000. Finally, Country X again receives \$500,000 in tax revenues and is in the same position as before.

Analysis. These two fact patterns demonstrate, contrary to frequent assertions, that a seller cannot avoid the economic impact of a local country tax through an offshore sale. Such a sale, even if not currently taxed, does not deprive a developing country of tax revenues. Notice that in such a case Investor A bears the full brunt of the Country X tax. Buyer's calculation of the price it is willing to pay to Investor A is based on the after-tax cash flow that it expects from the well. Even though the well generates \$1 million of revenues, Buyer is only willing to pay \$500,000 to Investor A since Buyer will also owe tax of \$500,000 over the life of the well. Country X is kept whole, receiving its \$500,000 of revenue.

Nonsymmetrical Treatment Cases

Case 1: Seller's Gain Taxed/No Deduction for Buyer. Under these rules, Buyer will only break even by paying Investor A \$500,000 for the well because that is the expected after-tax cash flow from the well (\$1 million pretax income minus 50 percent income tax). For Investor A, a payment of \$500,000 is insufficient because the sale would be subject to \$250,000 of tax by Country X (\$500,000 x 50 percent income tax). Therefore, Investor A's after-tax cash is only \$250,000. This results in an effective tax rate of 75 percent, that is, double taxation.

Some may argue that this tax result is favorable for Country X because it will receive \$750,000 of tax revenues, but it is unlikely that this will ever materialize. As stated previously, the sales transaction will only take place if Investor A and Buyer can arrive at an agreeable price. Under this tax regime, the likelihood of that happening is extremely low. It is far more likely that the sales transaction won't take place. Investor A will remain operator of the well, and Country X may

lose a more efficient operator or one more willing to make additional investments.

Case 2: Seller's Gain Not Taxed/Buyer Deducts Purchase Price. Under these rules, Country X would subsidize the sales transaction between Investor A and Buyer. For the reasons above, Buyer would be willing to pay \$1 million for the well. Seller would receive a windfall in this case because the after-tax cash to the seller would be the full \$1 million if the sale is not subject to tax. Country X would receive no tax revenues under this regime.

The Capital Gains Decision

A tax regime that provides symmetrical treatment for a seller and buyer protects the country's revenue and does not present an economic impediment to investors seeking to maximize efficiencies.

Even if a system is designed to create symmetry, the question remains: Which approach is better: 1) Taxing the seller's gains and providing a step-up in basis to the buyer; or 2) not taxing the seller's gains and requiring the buyer to carry over the seller's basis (in effect, not permitting the buyer tax deductions based on its purchase price)? This is ultimately a question of timing. For example, under the example above, if the gains are taxed, then Country X receives a lump sum of \$500,000 in year 1 and then nothing in future years. If the gains are not taxed, Country X continues to receive a steady stream of \$50,000 in revenues for the next 10 years.

Which is best for Country X?

- As noted, the present-value cost of an outlay to an investor (for example, a tax payment) is generally more than the present-value benefit to a country from an acceleration of a payment, given their discount rate differences. Thus, value — which otherwise could benefit both the investor and the country — is lost when, all other things being equal, a country accelerates a tax cost.
- Many other factors come into play, but one additional item that a country might consider is how it would account for a one-time acceleration of expected revenues for budgeting and spending purposes. Would such a one-year spike in revenues be viewed as such and effectively "saved" for use in future periods, or would other pressures force government officials to spend the revenues when received? Alternatively, would it be better from a fiscal management perspective to maintain a steady stream of income throughout the future years?
- These are among the considerations a country will need to weigh in making its policy decision on this important issue.

Indirect Sales Additional Points

When a country evaluates whether it should tax indirect sales, several additional issues arise.

First, the overall benefit should be determined, given that it is in fact only one of timing.

Next, the costs of such an approach should be evaluated. The costs to investors may reduce overall country investment in general. The administrative issues and costs of implementing and enforcing such an approach also should be considered. The country will need to decide how best to achieve tax symmetry (that is, how it will deal with the stepped-up basis issue noted above) and how it will prevent other double taxation possibilities.⁹ Also, the country should consider the scope of its tax jurisdiction, the impact of its treaty provisions, how it will identify and track transactions, which transactions it may wish to exempt,¹⁰ its enforcement capabilities, and the allocation of its tax administration resources.

After undertaking this cost-benefit analysis, a country may still decide to tax indirect transfers. Equally, a country may determine that the difficulties that approach creates are simply not worth the limited timing effects in revenue collection. ♦

⁹There are several issues that can give rise to a conflict of interpretation and double taxation in the case of indirect transfers. Examples include: (i) alienation of shares of a holding company owning a participation in more than one subsidiary in the source country (for example, a subsidiary that falls under the immovable property rule and another subsidiary that does not fall under this rule) but, because the source country uses a consolidated valuation method (versus a value test applied separately to each of the subsidiaries), the indirect capital gains rule is triggered for both subsidiaries; and (ii) the alienation of shares of multi-tier groups (for example, alienation of a top holding with a chain of subsidiaries resident in different states). Moreover, if a particular production-sharing agreement attributes joint or alternative tax responsibility to the acquirer, multiple taxation might derive from a single transaction.

¹⁰Indirect transfers potentially subject to tax can have a very broad scope and apply even when an investor sells shares representing a very low interest of the capital in the immovable company. The OECD commentaries acknowledge the broad scope of the provision but suggest countries may restrict its application to cases when the alienated shareholding exceeds certain thresholds. They further point out that countries are free to exclude from the scope of taxation gains derived from the alienation of listed companies. (See paras. 28.6 and 28.7 in the commentaries on article 13 of the OECD model tax convention.)

COMING ATTRACTIONS

A look ahead to upcoming commentary and analysis.

U.S. income tax treatment of Australian superannuation funds (*Tax Notes International*)

Roy A. Berg and Marsha-laine Dungog identify areas in which the U.S. Treasury and IRS should issue guidance on the treatment of Australian superannuation funds owned by U.S. persons.

Mexican service companies come under challenge by the tax administration (*Tax Notes International*)

Manuel Solano, Koen van 't Hek, and Terri Grosselin discuss a recent Mexican court decision regarding a VAT refund request and the legal status of a service company.

Condemning Treasury's interpretation of the cap on ABLE accounts (*Tax Notes*)

Stephanie Hoffer examines the purpose of section 529A tax-favored savings vehicles and argues that if individuals with qualifying disabilities contribute and withdraw money in the same year, those funds should not count toward the annual limit.

VAT: Has the time come? (*Tax Notes*)

Jim Leet argues in favor of implementing a VAT and says that doing so would stimulate economic growth and increase wages.

DMA v. Brohl — 'Son of Quill'? (*State Tax Notes*)

David Vistica and Jeremy Sharp contend that the long road traveled by *Direct Marketing Association v. Brohl* has created two approaches for states seeking to challenge the *Quill/Bellas Hess* sales and use tax physical presence standard.

Test results from Massachusetts's energy laboratory (*State Tax Notes*)

Patrick Dowdall discusses two legislative developments and a decision by the Supreme Judicial Court of Massachusetts that have happened in the last six months regarding the state's incentives for renewable energy.