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7.4 Special Fiscal Topics and Provisions

7.4.1 Fiscal Prices

Price determination for fiscal purposes can be complicated in the EI sectors. In all cases, the goal in tax administration is to set or agree to a fair price for tax purposes which is as close as possible to that which would be realized in a genuine third party, arms-length market sale. This is important for several reasons:

1. to avoid fiscal revenue loss by under-pricing of the resource (see the section on Transfer Pricing below);
2. to avoid government over-pricing of the resource to raise revenues; and
3. to help ensure the availability of foreign tax credits to investors (see the section on Foreign Tax Credits below).

The goal is most easily accomplished in the case of oil where well-established international markets exist and price quotes, together with price adjustments for crude oil quality and transport differentials, are almost continuously available. The fiscalization point (at the point of export, ex-field, or another agreed point of delivery) has to be agreed but need not present particular difficulties as long as associated taxes or royalties are adjusted to reflect the choice made. Establishing fiscal prices for mining and natural gas is more problematic in the sense that their markets may be harder to identify or observe.

In the case of gas, competitive markets currently exist only in the US and the UK; readily observable prices for fiscal purposes do not exist outside those markets and are often set on a project by project basis. Further, the marketing of natural gas and some minerals may be integrated all the way from the petroleum field gate or agreed delivery point or mine-mouth through processing or smelting and transport all the way to final consumer with different tax regimes applicable along the integrated chain. Setting the value of the resource along that chain will, as a result, have significant implications for total fiscal revenues and their sharing among fiscal jurisdictions. Good practice generally calls for netting the price paid by the final consumer back to the agreed field gate or delivery point or mine-mouth in such a way that rents accrue at those resource extraction points.

7.4.2 Transfer Pricing

Transfer pricing refers to the pricing of sales to, or purchases from, parties affiliated with the EI sector investor. It applies not only to the sale of products and goods but also to the supply of services and the terms and pricing of loans or credit instruments such as pre-financing arrangements. More than one half of all cross-border transactions carried out are likely to be between companies that are affiliated, so the importance of this subject should not be underestimated¹. Transfer pricing is considered abusive when under-pricing a sale or over-pricing a purchase results in shifting profits from a host state resource extraction jurisdiction to a lower tax jurisdiction outside the EI host state – with the result that the tax payments to the host state are reduced.²

Vulnerability to abusive transfer pricing is a feature that is not unique to the extractives sector. However, very high taxes on exploration and production increase the risk of abuse, and are compounded by the fact that many of the investors in the extractives sector are integrated international companies and often use tax havens as corporate locations. Activities such as production, refining, marketing and distribution of the resource could occur in several tax jurisdictions, creating opportunities for transfer pricing. Similarly, excessive fees could be claimed for managerial and technical services shared by a company's international operations.

Monitoring and policing inter-affiliate transactions can be difficult, but very far from impossible. Three features of extractive industries contribute to assist government authorities in their tasks³:

1. There are observable physical operations and outputs;
2. There are standard measurements and benchmark international prices, which can produce a comparable uncontrolled price with which to value transactions; and
3. In the hydrocarbons sector at least, there is commonly a joint venture structure that triggers conflicting interests that work in the favour of public authorities in controlling costs.

Tax authorities are well-advised to set clear, transparent rules and procedures for tax treatment of inter-affiliate transactions⁴. Abuses with respect to both sales and purchases (interest costs, or sub-contractor goods and services) can be mitigated by:

¹ Mining Contracts: How to Read and Understand Them: <http://www.resourcecontracts.org/blog/guides-to-contract-terminology.html>, p. 96.

² Sunley, Baunsgaard, and Simard (2003), at pp. 157-158.

³ IMF (2012), p.37.

1. preparing tax returns, for the purpose of tax assessment, using either an advance pricing agreement for any inter-affiliate transactions, or agreed *ex ante* prices, or arm's length market prices with benchmarking by reference to observable markets (as suggested in the preceding paragraph for pricing of sales);
2. requiring investors to provide both advance notification each year and an annual projection of the value (in terms of price and quantities) of any planned inter-affiliate transactions and then, based on the information provided, setting a ceiling for such transactions beyond which they will not be eligible to be deducted for tax purposes;
3. requiring investors to identify all affiliated and non-affiliate transactions and justify their pricing (this can be an important tool in building up data for the enforcement of transfer pricing rules); and
4. referencing or incorporating into local legislation the OECD guidelines on transfer pricing⁵.

It is not unknown for companies to attempt to reduce tax assessments by having highly leveraged capital investment programs with as much as 95 percent debt financing, a percentage that is considered much higher than prudent.⁶ This can happen especially where a subsidiary company takes on excessive debt while the parent company maintains more prudent debt levels. The problem here, however, is more than one of the subsidiaries taking on imprudent debt. It is rather that they are characterizing parent contributions as debt rather than equity simply to minimize taxes (and equity payments to other, including state, shareholders. In many cases, this is not real debt, but related party debt that is simply characterized as debt.

In the case of interest costs, extra protection may be provided by not only benchmarking rates against observable market rates, but also by limiting the total debt allowed for purposes of tax calculations in the host state to a set debt-equity ratio ceiling (for example, a three to one ratio). Other, simpler approaches are receiving increasing attention and use, such as limiting interest deductions to a set share of income.

Good Practice

The burden should be on the taxpayer to use the rules and to demonstrate that it has done so.

⁴ The OECD has published a set of Guidelines that describe a sequence of acceptable methods for setting transfer prices: OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010: http://www.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en; <http://download.pwc.com/ie/pubs/2014-pwc-ireland-oecd-guidance-tp-and-cbc-reporting-25-09-2014.pdf>

⁵ OECD Guidelines, id.

⁶ Sunley, Baunsgaard and Simard (2003) Id.

Published benchmark prices should be used where they are available.

Tax authorities need robust data collection programs to support a coherent audit strategy.

7.4.3 Ring-Fencing

Ring-fencing is a CIT measure that aims to limit the consolidation of income and deductions for tax purposes across different activities or projects which are carried out by the same taxpayer. This has the advantage of ensuring government revenues where an investor carries out a series of projects and seeks to deduct exploration or development expenditures from each new project against the income from projects that are already generating taxable income. Norway and the UK, for example, have a sector-wide ring fence for offshore petroleum, preventing non-sector activities to be deductible from the petroleum extraction sector and vice versa, which is a recognized good practice. If deferral of revenue is a concern, it could be done on a license basis instead.

This is a cost recovery issue with important consequences for both the pace of exploration and development activities and the timing of government revenues. Ring-fencing limits cost recovery from the revenues of a particular producing petroleum or mining project to costs which are incurred in the same project or license area. This has two consequences. The first is positive; ring-fencing avoids the delays in government revenues which might otherwise result if investors were allowed to write-off new expenditures or investments made outside the producing area against producing area income. The second may be viewed as negative to the investor: ring-fencing does not permit the right to consolidate new costs with existing income for fiscal purposes, eliminating an incentive to spend on new exploration and development. If the government were to allow costs to cross, or be consolidated across, a ring-fence it may, in effect, be subsidizing unsuccessful operations. However, this eliminates only the incentive with respect to existing producers. Many states will want to encourage new investors to come in, and here ring-fencing may help to create a level playing field. New entrants have no in-country income against which to offset exploration costs, so they are at a disadvantage vis-à-vis existing producers which will face lower costs for exploration; this is another argument for ring-fencing.

Policy-makers face a trade-off between early revenue with deferred activity, and accelerated activity with delayed revenue. How the trade-off is resolved will depend on both country context and country priorities.

Certain fiscal instruments require ring-fencing to make any sense whatsoever. A good example of this is a Resource Rent Tax or an additional profits tax related to a project.

7.4.4 Decommissioning Costs

Petroleum and mining investors are now almost universally required to 'decommission' the site of their operations once operations cease (decommissioning requires the investor to rehabilitate the site and restore or remove any causes of danger or injury to the environment). Since there is no income against which to recover the costs involved once operations cease, investors may simply leave the government to bear the cost of reclamation. To forestall this, detailed rules need to be made providing for plans and budgets, and for cost deduction against them. It is now common to require that investors establish from a pre-determined date a decommissioning fund or mine reclamation fund in advance of termination of operations. This may be carried out through payments made ahead of closure based on estimates of decommissioning costs and placed in an escrow account at an approved bank. This guarantees payment. Under good practice, those payments are cost recoverable under a PSC or tax deductible for CIT from a given date in accordance with special rules. The decommissioning costs are, however, tax deductible *only when incurred* under a royalty/tax regime when the tax legislation contains a satisfactory carry back provision and guarantees that the taxpayer may benefit from an appropriate tax relief as in the UK. Mining differs from oil and gas in that decommissioning takes place in phases during mine operations and not only after the mine is closed. Decommissioning costs incurred in advance of closure are normally allowed as deductible expenses.

7.4.5 Infrastructure Obligations

Investors may sometimes be obligated to provide the host state with social or physical infrastructure as part of their contractual undertakings (see **Chapter 9**). This is tantamount to earmarking government revenues. The motivations behind the requirement may have to do with lack of government capacity or with political expediency. Whatever the motivations are, except where the expenditure is allowed as a full credit or offset against the investor's tax obligation, the requirement is analogous to an explicit tax on the investor. The scale of such a tax depends on: (1) whether or not the infrastructure expenditure is deductible; (2) on the actual cost of the infrastructure to the investor; and (3) continuing upkeep obligations. Further, since some infrastructure may be used in servicing the mine, it would represent business expenses rather than full taxes. Shared use by other operators (such as railways or ports) will further complicate any such analysis.

7.4.6 Fiscal Stabilization

A major concern of investors, noted elsewhere in the *Source Book* (**Chapter 4** for example), is the perceived lack of credibility on behalf of the host state to refrain from introducing adverse terms – especially, but not exclusively, fiscal terms – once risks have been borne and major expenditures sunk. This is sometimes called the ‘time inconsistency’ problem by economists. These concerns have been at least partially addressed by introducing stability clauses in legislation or, more commonly, in licenses or contracts.

In practice, two formulations of contractual fiscal stability clause can be found: the frozen law formulation and the economic equilibrium formulation. Under the frozen law formulation, the laws in force when the agreement was signed are frozen for the life of the contract or for a period of years.⁷ Under the second approach (now more common), the parties to the contract agree to negotiate in good faith to maintain the original economic equilibrium of the contract by introducing compensating changes to any adverse revisions to applicable laws or to the contract itself.⁸

A growing reluctance to accept stability clauses is emerging on the part of governments.⁹ However, without a track record of broad-based improvements in governance, it seems likely that such provisions will continue to be sought by investors and granted by states as a way of improving their competitive position in attracting investment¹⁰. At the same time, it is increasingly recognized that good fiscal design (by providing for automatic responsiveness of terms to changed circumstances) can reduce pressures to renegotiate or revise agreements, making it less likely that stability clauses will be invoked.

7.4.7 Foreign Tax Credits in Home Country

Whether or not a credit is available in an investor’s home state for income taxes paid to the host state is an important consideration for investors whose home states apply a system of worldwide income taxation (for example, states that tax foreign

⁷ Cameron, P. (2006). *Stabilization in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil and Gas Investors*, Final Report. London: AIPN: www.aipn.org.

⁸ *Id.*; see Cotula supra note 116, at p. 69.

⁹ Cotula, supra note 116, at p. 16-17.

¹⁰ On the design and effectiveness of contractual assurances, see Cameron, P. (2010). *International Energy Investment Law: The Pursuit of Stability*. Oxford: Oxford University Press; Cameron, P. (2013) *Reflections on Sovereignty over Natural Resources and the Enforcement of Stabilization Clauses*, in *Yearbook of International Investment Law 2012*. Oxford: Oxford University Press, chapter 7; Daniel, P. (2010). *Contractual Assurances of Fiscal Stability*, in Daniel, P. Keen, M. McPherson, C. (2010). *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*. London: Routledge.

source income in the home state).¹¹ Most host states are aware of this issue and adjust their resource tax regimes to ensure the availability of foreign tax credits. This can be done without prejudice to host state tax revenues and has the benefit of encouraging inward international investment. Criteria for foreign tax creditability include:

1. a host state tax based on net income (ideally closely resembling the income tax applied in the investor's home state);
2. use of actual third party market prices or equivalent benchmarks in the calculation of host state taxable income; and
3. allowable deduction of all significant costs attributable to the taxed operation.

Some specialized resource taxes such as rent taxes, additional profits taxes, or payments under production sharing arrangements may be considered to differ in nature from a standard corporate tax and face difficulties in qualifying for a credit. The treatment of these taxes can be clarified in a double tax treaty (see the section on Tax Treaties below). Home states may limit the total credit available to what would have been paid in the home state absent a credit. Host states will want to package their EI sector taxes, including for the selection of applicable income tax rate, to maximize the home state credit available to investors and thus avoid any leakage of potential tax revenue to the home state.

7.4.8 Tax Treaties

Large numbers of international treaties have been concluded to prevent double taxation of the same income or profits by two different governments. They were not intended to be used to generate double non-taxation as it has occurred under treaty shopping. There are more than 3,000 such treaties in existence, "in which two countries agree on how and when each will tax activities of the residents (persons and legal entities) of the other with respect to certain items of income"¹².

Tax treaties between home and host states often reduce withholding tax rates imposed by statute on dividends, interest, management or technical service fees due by the subsidiary located in the host state to their home state parents. This is aimed at cases where the parent company has its head offices (and head office staff)

¹¹ The US, UK, and Japan all have worldwide tax systems and investors resident in those countries will have foreign tax credit concerns. Australia, Canada, and France are called territorial tax systems because they exempt foreign source income from tax in the home state of the investor. This is done so that the investor is taxed only in the source or host state.

¹² 'Mining Contracts', id, p. 102.

domiciled in the tax treaty state. A host government may negotiate different withholding taxes for different treaty partners.

The risks to the host government are that the tax base of an extractives project may be significantly eroded and the permitted levels of withholding taxes may be reduced or even eliminating them altogether.

For countries with significant inward flows of investment into their extractives sectors, and negligible outward investment flows of their own, it is necessary to design treaty strategies to minimize the risk of such tax base erosion and to adopt rules to prevent ‘treaty shopping’: routing and characterizing remittances to intermediate jurisdictions so as to exploit advantageous treaty provisions. Tax treaties can also limit a government’s ability to tax non-resident entities on capital gains.

If these treaties have special provisions on EI, their aim will be to ensure source taxing rights on income from extractives activities, by expanding the general definition of ‘permanent establishment’ to include activities for the exploration and exploitation of natural resources, in addition to the usual coverage of a place of extraction such as a mine, gas or oil well¹³. The essential idea is that oil, gas and mining exploration and production activities are treated as attributable for tax purposes to a permanent establishment in the host country, where the business has an enduring presence, so that the source country has the taxing rights on the profits of the business. The investor is not being encouraged to reduce or delay the amount of tax payable at source but rather is being made subject to tax *only once for a given source of revenue*.

Since many companies in the EI sector are multinational in character, the treatment of their foreign source income in their countries of residence is very important to them. This is particularly so when the countries concerned have global taxation regimes (foreign source income earned abroad is taxed in the taxpayer’s country of residence), as in the USA or UK. If foreign tax credits are available for taxes paid by the multinational in the source country, they can offset home country taxes¹⁴. Obviously, where this is permitted, there are detailed rules governing its operation¹⁵. Such double taxation treaties are modified from time to time to take into account changing global tax practices.

¹³ Mullins (2010),

¹⁴ Mullins, P. (2010) International Tax Issues for the Resources Sector, in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*. London: Routledge, p. 384-388.

¹⁵ See the discussion about the US regime in Johnston, D. (1994). *International Petroleum Fiscal Systems and Production Sharing Contracts*. Tulsa: PennWell, pp. 191-202.

In situations where tax treaties do not exist to prevent double taxation, some parent companies may be tempted to set up an intermediary ‘paper’ company in a tax haven as the owner of the subsidiary company in order to gain those tax benefits. Governments can prevent this by including provisions in their tax laws which deem such practice as tax evasion, subject to substantial penalties.¹⁶ In recent years tax treaties have attracted critical scrutiny: as one authority notes diplomatically, “the experience of resource rich countries in entering into double tax treaties varies”¹⁷. Such treaties make sense in cases where there are relatively even flows of capital between signatory countries but where capital flows mainly in a single direction which is the case in most resource-rich poor countries, the basis for such treaties is less clear, since they work only to decrease host state revenues¹⁸.

7.4.9 Confidentiality

While all EI states have a fiscal regime embedded in the law, some states have also negotiated and signed separate, generally confidential, EI sector agreements that contain ‘special deal’ fiscal regimes that are unknown except to the investor, the tax authority, and a very small number of officials who have access to the agreement.¹⁹

During the commodity boom of 2007 and 2008, a number of these agreements in the mining sector came to light when governments found that tax payments did not increase commensurate with profitability because of fiscal concessions made in the contracts. By keeping the mining fiscal regime in the law and refraining from modifying it in separate confidential agreements, or making public such agreements governments and the state at large will have full knowledge and transparency regarding the tax regime, and the risk of corrupt practices, poorly informed decisions, and mismatched negotiating capabilities can be avoided.

7.4.10 Gas

Petroleum tax laws usually provide specific clauses on gas to enable more favourable terms for gas operations, since the profitability of gas projects is often lower relative to oil projects²⁰. The reasons, according to H. Le Leuch, are twofold: upstream gas operations are often more costly, and gas is sold at a lower equivalent caloric value

¹⁶ Calder, J. (2010). Resource Tax Administration: The Implications of Alternative Policy Choices. In: Daniel, P., Keen, M.; and McPherson, C. (eds.). *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*. London: Routledge, p. 333.

¹⁷ Mullins (2010), p.388.

¹⁸ See recent IMF seminar on this subject and forthcoming book (planned in 2015).

¹⁹ For a critical discussion of contract confidentiality, see Rosenblum, P. Maples, S. (2009) *Contracts Confidential: Ending Secret Deals in the Extractive Industry*. New York: Revenue Watch Institute.

²⁰ Natural gas liquids including condensate are usually treated as oil for fiscal purposes however under both tax law and contracts.

than oil²¹. However, the incentives will vary according to the kind of petroleum contract that is adopted. If adjustments are required under the existing fiscal regime, the following tools may apply:

- Under licence or tax/royalty arrangements, reduced royalty rates for gas (for example, in Nigeria, Tunisia and Vietnam);
- Under PSCs, where most of the fiscal differences between oil and gas are of a contractual nature through more favourable cost recovery schemes and production split terms applicable to the investor in the event that there is gas production (for example, Egypt, Indonesia, and Malaysia). In an Indonesian PSC the contractor may often have a share of 25-35 percent in the profit oil split on a post-tax basis but for gas its share may rise to as much as 30-40 percent;
- Lower tax rates (for example, in Nigeria, Tunisia and Papua New Guinea); and
- Exemption from certain petroleum taxes (for example, in Trinidad and Tobago exemption from the Supplementary Petroleum Tax).

Both tax/royalty and production sharing contract regimes have recently introduced new fiscal devices however. These are designed to take into account the differences in economics between oil and gas. Examples include the additional profits tax instrument under a tax/royalty arrangement and a progressive petroleum profit sharing scheme triggered by an economic criterion (such as the achieved rate of return of the project or a multiple of the investment incurred – the so-called R-Factor). These are becoming more common and by relating rent sharing to the effective profitability reached by the project, they can address oil and gas activities in the same terms.

However, the specific tax regime introduced for the upstream oil and gas sector is in contrast to the typical practice for fiscal regime design for downstream activities. The regime applied to gas downstream often consists of the general tax code of the country applicable to gas in the same way as to any other sector of the economy. Downstream gas operations will tend to be treated as general industrial projects and subject only to standard corporate income tax.

Two contractual practices are sub-optimal:

First, the tactic of postponing stipulation of detailed fiscal terms for future gas discoveries, leaving them to be negotiated at a later stage, when a potentially viable discovery has been made. This creates a disincentive to the investor to search for gas and appraise a gas discovery: if commercial quantities of gas are found, the

²¹ Le Leuch (2012), Gas Guidance Note, at 5.2, p.27. The following paragraphs are based on this text.

government may regard them as having no rights at all, and even invite them to negotiate for a role in competition with other potential investors.

Second, the approach of using terms for oil to apply to gas when the fiscal scheme is based on equivalent production sharing scales²². The strong likelihood that the expected price of gas will be lower than that of oil would not be taken into account.

7.4.11 Small Scale Mining

The operations of artisanal and small-scale miners have attracted considerable attention (see **Chapter 9** for discussion of legal and environmental issues), not least because of their numbers in countries like Brazil, Ghana, Sierra Leone, Suriname, Tanzania, Thailand and Zambia. The fiscal issues arising from this sector are few, and are comparable to small-scale agriculture rather than large-scale mining. Emerging good practice, as in Ghana for example, is to levy royalties on traders by requiring them to withhold and pay – instead of attempting to tax miners directly, except perhaps for a small licence fee, and ensuring that consumption taxes are levied and collected in mining areas.

²² For natural gas liquids, also a by-product of oil production, their treatment as crude oil for legal and fiscal purposes is generally appropriate from an economic point of view. Condensate tends to achieve similar prices to those of oil so their revenues should logically be treated the same as those from the sale of oil, and subject to the same fiscal terms: G Kellas, Natural Gas. In: Daniel, P., Keen, M.; and McPherson, C. (eds.). *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*. London: Routledge, pp. 163-183.