

# CHAPTER 7 – [www.eisourcebook.org](http://www.eisourcebook.org)

## 7.5 Fiscal Administration

Many of the requirements and procedures apply equally to fiscal administration of EI and fiscal administration generally. The United Nations has classified the following actions as essential functions of *any* fiscal administration:

“In order to execute its basic mission, a tax administration performs certain fundamental functions: taxpayer registration and identification, assessment (including valuation), collection and audit. These functions have been classified as ‘essential’.... The ‘essential’ functions have also been labelled ‘operational’, since they involve the actual collection of taxes and entail close relations with taxpayers...”<sup>1</sup>

The OECD likewise defines the basic functions of a “tax administration” as including assessment of taxes, including imposing sanctions to deter and penalise non-compliance, and the power to obtain relevant information from taxpayers.<sup>2</sup>

Given the very large amounts of money that are typically involved in oil, gas and mining, and the transformative potential that they have, it is critically important to get the fiscal administration ‘right’<sup>3</sup>. A fiscal regime that is well-designed but *poorly drafted or implemented* may fall far short of its tax-raising potential. The non-renewable character of the resources concerned underlines the importance of sound fiscal administration. The irony is that in the EI sector the bulk of the revenues are often paid by a very few large taxpayers, so the scale of administrative capacity required should not be large. Moreover, for the investors the maintenance of good relations with the host government will tend to be of great importance. A basis for success in fiscal administration of the extractives does exist.

*Careful identification of fiscal objectives and selection of fiscal instruments is of little use if fiscal authorities prove incapable of implementing the resulting regime.*

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<sup>1</sup> U.N. Dep’t for Dev. Support & Mgmt, Guidelines for Improving Tax Administration in Developing Countries (1997) at p. 19.

<sup>2</sup> See Ex. 2, OECD, ‘Tax Administration 2013: Comparative Information on OECD and other Advanced and Emerging Economies’, at pp. 273-295 available at: [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/tax-administration-2013\\_9789264200814-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/tax-administration-2013_9789264200814-en#page1) (last accessed 12.1.2015).

<sup>3</sup> Highly recommended are two chapters by J Calder in Daniel, P., Keen, M.; and McPherson, C. (eds.) (2010). *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*. London: Routledge: ‘Resource Tax Administration: The Implications of Alternative Policy Choices’, pp. 319-377; and ‘Resource Tax Administration: Functions, Procedures and Institutions’, pp. 319-377.

**Tax Policy and Administration** A number of the key fiscal objectives identified at the beginning of this Chapter argue in favour of a progressive, profits-based tax regime. Critics have faulted these regimes on grounds of their perceived complexity and difficulty of administration. However, the simpler systems with which the critics would replace them (such as royalty-based regimes) have drawbacks of their own in terms of assessment, efficiency or fiscal neutrality. The conclusion seems to be that countries should use a mix of instruments based on well drafted fiscal rules.<sup>4</sup>

A way of resolving this dilemma would be to opt for the simpler, but less efficient, tax design as a starting position, while adding capacity and transitioning towards something more sophisticated. In assessing these trade-offs, it is worth bearing in mind that the ease of administration associated with simpler fiscal regimes may be, and often proves, deceptive. Their economic drawbacks can lead to pressures for renegotiation, legislative amendments and/or special deals which, in the end, will considerably complicate administration.<sup>5</sup>

Finally, it should be recognized that administration of the more sophisticated EI sector tax regimes requires no more, or very little more, capacity than that required to administer any income tax. To reject these regimes because they are profits-based or income-based suggests there are much broader fiscal administration problems than those associated with the EI sectors alone.

In cases where a state lacks the necessary capacity to administer a profits-based EI sector tax regime, or where such a tax regime is not available domestically (or both), there is a way forward open to them. They can quickly put in place the capacity through the use of foreign experts who could not only undertake and lead specific assessment and field auditing tasks, but could also provide on-the-job training to build the capacity and experience needed for state-based staff to be able to take on those roles over time.

**Routine Administrative Functions** Routine functions are about the mechanics of gathering tax: registering taxpayers, design return templates, publishing guidance notes on fiscal rules, processing returns, issuing tax assessments, and collecting the tax. A number of considerations should make the job of routine administration easier in the EI sectors. The oil, gas, and mining companies participating in the EI sector tend to be relatively few in number, easy to find, and for the most part willing and able to carry out routine tax obligations. Additionally, adoption of self-assessment procedures should facilitate routine administration by transferring many routine tasks to the taxpayers.

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<sup>4</sup> For illustration, many disputes continue nowadays to exist in the USA regarding the determination of *ad valorem* royalties mainly caused by loopholes in the lease drafting.

<sup>5</sup> For the case of mining, see ICMM, *supra* note 181, at pp. 9, 37.

### Box 7.5: Routine Tax Administration: Challenges

Many developing states have encountered enormous difficulties in routine EI sector tax administration which are traceable to:

1. **Number of Taxes.** Too many different EI sector taxes with differing filing and payment rules, poor fiscal procedures and forms, absence of guidance notes and accounting rules adapted to the sector creating uncertainties.
2. **Number of Agencies.** Different agencies for different taxes.
3. **Banking and Accounting.** Different arrangements for different taxes.
4. **Technology.** Poor information technology (IT) and management information systems. No IT network connecting different agencies.
5. **NRC (national resource company).** Limited or no control over NRC tax payments.
6. **Accountability.** No one person responsible for the whole job.

These advantages notwithstanding, many developing states have faced enormous difficulties, traceable to the obstacles or challenges of the type listed in **Box 7.5** below. As Box 7.5 illustrates, building capacity is not simply a matter of skills, but also very much a matter of attention to procedures, infrastructure or resources, and institutional organization. In addition, there are plenty of reasons why the administration might become complicated: for example, the complexity of the sector; lack of technical knowledge and knowledge asymmetries; absence of a chart of accounts adapted to the EI activities.

Steps required to simplify routine resource tax administration are immediately suggested by the obstacles themselves. While self-assessment – backed up by strong penalties for non-compliance and by effective audit and enforcement (major challenges in and of themselves) – may limit the risk of large direct losses attributable to weaknesses in routine administration matters. Poor routine administration and associated reporting will confuse economic and budgetary planning, undermine sector accountability and governance, and damage government's reputation with investors.

**Non-Routine Functions** These functions have to do with ensuring that the tax is calculated correctly. The most important among them deal with resource valuation (prices and volumes), allowable cost deductions, audit and appeals, and dispute resolution. They are demanding functions which require professional skill and judgment. In this case, very large amounts of money are at risk.

**Resource Valuation** Valuation of petroleum or mineral resources needs to be established for both profits taxes and royalties. The challenges of establishing prices for this purpose are discussed in the preceding section. Similarly, physical or volume audits can be complicated. Volume measurement can be highly technical, involving complex equipment. Definition of sales point, valuation points and measurement points have to be clear.

**Audit** Under any fiscal regime there is always scope for error, differences of opinion, or unacceptable manipulation. Where petroleum or mining are concerned, even marginal errors in incomes or costs can involve very large sums of money; hence the importance of effective tax audits. The ideal starting point for effective audit is a clear, well-designed tax, supported by clear instructions to both taxpayers and administrators alike in the form of a public, regularly updated taxpayers' manual. Fiscal administration of the EI sector, like other sectors of the economy, is based on a self-assessment system whereby companies prepare and submit tax returns according to their understanding of tax rules. In a tax administration system that is based on self-assessment, field tax audits of EI sector enterprises, led by qualified and experienced staff, are essential to reduce the risk of substantial underestimation in tax assessments since companies will always interpret tax rules to their advantage unless audited.

A key weakness in many states is that tax administrations do not undertake field tax audits and, where they do, are at a great disadvantage given that EI sector tax returns are generally very large and complicated relative to most other tax returns in developing states. Thus, obtaining the services of qualified tax auditors experienced in undertaking tax audits of EI sector companies is essential; this is not only important for undertaking audits, but also for ensuring that all the necessary accounting rules and audit procedures are in place. Establishing the accounting rules in advance is essential in order to have a benchmark to audit against.

In addition, the auditing task can be made much more manageable if tax administration staff become familiar with the enterprises they are auditing and also obtain annual projections from each enterprise and each project on a quarter-by-quarter basis of expected tax assessments. The tax authority staff and auditors then have an initial reference point when examining the actual assessments. EI sector projects involve a variety of activities such as exploration work, development work, co-production of different products, decommissioning, reclamation, and restoration which are not found in other businesses and for which the accounting treatment may have significant implications for tax assessments.

The procedures for selection of exchange rates will also need very careful attention. The tax authority will be well-served to agree on a detailed accounting treatment for

these various activities and projects. Ideally, the tax administration staff – together with the EI sector ministry staff – should have computerized, financial models of each of the operations and enterprises, preferably using inputs received from, or agreed with, the companies.

In the petroleum industry, tax audits are assisted by the common practice of investor joint ventures whose rules provide not only for detailed (and increasingly standard) accounting for costs and revenues but also for partner audits of the joint venture operator. The special accounting rules and chart of accounts for the sector have to be issued or agreed before the commencement of activity

The mining industry, to date, has not been characterized by either unincorporated joint ventures or the kind of standardized accounting procedures found in the annexes to PSCs, which makes tax audit more difficult. Different states take different approaches on audit coverage; some opt for full investor coverage with comprehensive field audits and others adopt a varied approach that combines risk-assessed field audits of selected companies with desk audits of others. For large EI sector companies, annual audits are usually desirable given the significant amounts of tax at risk. Due to the large amounts of tax involved, an effective tax audit usually repays the cost of the audit many times over in terms of agreed adjustments to payments. Both interest and penalties on any tax increase resulting from the audit should be charged. Some of the specific features of the oil, gas and mining sectors are identified in **Box 7.6** above.

**Dispute Resolution and Appeals** Resolving tax disputes by formal litigation can be extremely expensive and slow. The preferable route is to settle differences by mutual agreement during the audit. If disputes remain unresolved, investors must have some formal right of appeal to tax courts or tribunals; in this case, credibility and a reputation for non-discriminatory handling of appeals is of fundamental importance. The tax authority should also have readily accessible expert legal capacity (either on its staff or as outside counsel) so that disputes can be taken with confidence to the tax court in the event that it is necessary to do so.

**Institutional Structures** In most sectors of the economy, tax administration is the responsibility of the national, or in some cases (such as Canada and Argentina), the provincial, and tax authority. For petroleum, however, tax administration may be assigned to the EI sector ministry or, more commonly nowadays, shared with the tax authority and/or the finance ministry. A typical division of responsibilities would assign taxes to the ministry of finance and royalties to the EI sector ministry or the NRC. The rationale advanced for this division is that physical measurement requires special technical expertise which is available only in the EI sector ministry. The same reasoning has made the EI sector ministry, or more often the NRC, responsible for

fiscal calculations under production sharing (for instance, in making cost recovery and profit oil sharing calculations).

While such divisions may appear logical, the spreading of fiscal administration among several agencies has disadvantages that include: increased complexity, duplication of effort, and reduced accountability<sup>6</sup>. Where differing institutional comparative advantage is perceived to outweigh the disadvantages of dispersal of administrative responsibilities and responsibilities are divided, clear definition of roles and responsibilities, regular communication, and effective coordination among the agencies involved becomes vitally important.<sup>7</sup>

**Inter-Agency Coordination** The tax authority and the EI sector ministry also need to coordinate closely in terms of production, costs and or sales data on which royalties and income taxes are assessed. The EI sector ministry should also work closely with the tax authority so that the tax authority has good comprehension of the production and exploration process and is able to make an informed judgment as to the eligibility of different charges and expenditures for tax purposes.

The central bank should not play any direct role in fiscal administration, but it is one of the key agencies that must be kept in the loop of communication and coordination. Ideally, all resource payments made to the government should go into a single unified treasury account held within the central bank. The fiscal authority should be responsible for preparing comprehensive accounts of payments assessed, collected, and paid into the treasury account; and these accounts should be capable of being reconciled with central bank accounts. In practice, the spreading of administration functions tends to have the effect that there is no single fiscal authority responsible for producing these accounts. A single, specialized office is preferable, either stand-alone or as a subdivision of another office (such as the main tax authority office).

Even when good accounting rules have been established, expert judgment may be needed to determine whether rules are being applied correctly; for example, whether or not exploration charges are being correctly assigned as development or green field exploration charges in situations where the two have different tax expense or depreciation rules. It will likely take the expertise of the EI sector ministry or the geological survey to determine if exploration activities have been correctly

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<sup>6</sup> The challenges of changing existing structures are underlined by some recent studies which go well beyond fiscal administration, such as those in Victor, D. Hults, D. Thurber, M. (2012) Oil and Governance: State-Owned Enterprises and the World Energy Supply; see also the paper by Thurber, M. Hults D. and Heller, P. (2010) The Limits of Institutional Design in Oil Sector Governance: Exporting the 'Norwegian Model': [http://iis-db.stanford.edu/pubs/22836/Thurber\\_Hults\\_and\\_Heller\\_ISA2010\\_paper\\_14Feb10.pdf](http://iis-db.stanford.edu/pubs/22836/Thurber_Hults_and_Heller_ISA2010_paper_14Feb10.pdf) (last visited 24 January 2013).

<sup>7</sup> Id.

categorized in the tax return. Technical expertise may also be needed in cases where EI sector companies claim tax deductions for intellectual property.

Finally, the importance of giving these offices the skills and resources they require cannot be overstated. Where requisite domestic skills are not immediately available, good practice would recommend engagement of qualified international audit, legal, or commercial consultants and twinning their support with the development of local capacity.

**Fiscal Federalism** The design and administration of a fiscal regime can be influenced by revenue sharing at the central, and sub-national levels. The horizontal fiscal disparity that can result from different layers of government will typically require a particular response, sometimes called fiscal federalism. This is discussed in **Chapter 8** at **section 8.8**. These elements can be intrinsically linked within the country concerned, as is the case in Indonesia, where, for mining, sub-national jurisdictions have the authority to issue local taxes as well as create differing administrative arrangements for the collection of mining royalties from the central government.

**CEPMLP**

**Centre for Energy, Petroleum and Mineral Law and Policy**

### Box 7.6: Fiscal Administration in EI

The taxation authority is responsible for administering a well-designed petroleum or minerals tax regime and will:

1. be familiar with the operations and profitability of each large EI taxpayer and large EI operation, and will cross check the additional tax calculations and data for consistency with other tax submissions such as profit taxes, dividend taxes, VATs, and customs declarations;
2. have financial models that provide tax projections for large operations and develop strong tax projection capabilities, including obtaining financial projections from large taxpayers;
3. develop a high degree of collaboration and cooperation with the mining or petroleum authority so that the technical competency is available to audit quantities, costs and prices and ensure the correct tax treatment of EI sector specific amortization rules, including for exploration expenditures;
4. develop strong tax audit capabilities, as well as, adequate rules necessary to protect inter-affiliate transactions being used to siphon off profits from the host state to another jurisdiction and thus reduce tax payments in the host state through improper transfer pricing (of sales and purchases of both products and services), thin capitalization, interest charges, and management or marketing fees;
5. have access to strong legal capacity in the event of disputes or legal action – relating to tax avoidance or tax evasion – is essential in order to be able to implement such procedures effectively;
6. include royalties to generate a minimum fairly stable flow of tax receipts providing that production and/or sales are taking place and that consist of:
  - a. a fixed charge per unit of production (or sales) royalty or preferably a fixed *ad valorem* royalty (which is a fixed percentage of the sales value at the agreed point of valuation); and
  - b. in some countries the unit or *ad valorem* royalty is collected by the mining or petroleum ministry;
7. include a suitable instrument (such as an additional profits tax, a cash flow tax, or a sliding scale royalty) to capture, in a progressive manner, a share of the economic rent ('excess profit') over and above the risk adjusted rate of return required for investment approval;
8. avoid tax holidays that distort investment and production decisions, and cause high grading before the tax holiday expires;
9. avoid tax free processing zones for mineral projects because mining and processing are capital intensive and provide very modest employment benefits;
10. consider import duty exemptions only if these do not adversely affect domestic industry (where there is a domestic industry); and
11. might include possible incentives to reduce risk for the investor such as:
  - a. accelerated capital recovery tax provisions for large investments, but in a manner where the government is fully cognizant that these will delay early tax payments;
  - b. tax stabilization clauses for a limited period of time, but these should be restricted to tax rates and should not stabilize loopholes or tax conditions that apply across the economy; and
  - c. double taxation treaties (DTTs) designed in accordance with the latest OECD and G20 recommendations, but legislation should require that a parent company's management and staff be located in the DTTs state to prevent 'treaty shopping' for tax avoidance purposes.