Answer-to-Question- 1

For upstream oil and gas purposes an (international) oil company may operate under a tax and concession regime, production sharing contract,service agreement amongst others. Each regime is designed with fiscal tools such as royalties, signature and production bonus,rentals,and direct and indirect taxes and state equity and carried interest. In this essay I seek to explain the mechanism and relevant of "state and carried interests" and the application of VAT and indirect taxes.

1. <u>State equity and carried interests</u>

In respect of this fiscal tool,the regime may provide for state equity which means the government share of the oil and gas development usually if the project is successful, say, after a commercial discovery is made. This share may be acquired on concessionary or full working interest terms but may be limited to a certain share such as 20% interest. Under the concessionary term, government acquires the equity stake in the oil and gas development at less than market value while for full working interest, government pays for the stake at market value.

State equity may be acquired through in-kind means such as reduction in tax liability of the oil and gas company or government's provisions of special and needed infrastructure such as access roads and construction of pipelines.

For carried interests, government's share of pre-production expenses is paid by the oil and gas company. The company carries the risk of not being reimbursed if the project is not commercially viable. If it is Government's equity share is typically paid by from its share of the oil.

State equity and carried interest are very relevant as they impact on the financial modelling of the investments. It should be taken into consideration to determine the return on the investment.

2. <u>Application of VAT and indirect taxes</u>

VAT is a general consumption tax on non-exempt goods and services collected at each stage of production or distribution.

In carrying out oil and gas operations, oil and gas companies will generally incur VAT and indirect taxes on their purchases. Credit will generally be available for deductible VAT costs if the petroleum produced is a taxable supply (including where it is zero-rated). If the petroleum is an exempt supply, then credit will not be available for the VAT cost incurred. In this case the VAT should be charged to the income statement or capitalised with the respective asset on the balance sheet unless the generally laws or petroleum agreement provides for a relief by way of refund or upfront relief - where the oil and gas company does not pay VAT at all on qualifying expenditure as provided in some petroleum agreements.

In several countries, especially, developing countries the ability to get timely refund is a difficult task. Oil and gas companies are therefore advised to take this into consideration when developing their models especially regarding the timing of cash flows.

In addition to or as an alternative to VAT, oil and gas companies may be subject to customs duties and associated levies on the importation of equipment imported to conduct their operations. Some countries provides some concessions where the items are re-exported such as in Brazil or when government will have the first right to acquire the asset when the oil and gas company wishes to dispose it off. Such concessions are usually spelt out in the specific petroleum agreement signed if not stated in the general laws. VAT on imported items may also not apply when customs and import duties exemptions is available.

In come cases international agreements such as the North American Free Trade Agreement (NAFTA) and related rules of origin rules may provide for some concession and these should be considered in making the investment decisions.

Export duties may also be applicable as an indirect tax on oil and gas produced and exported. In Russia for instance the rate of export duties could reach as high as 60% and it is therefore important this important source of revenue should be adequately planned for.

In summary, in addition to the main sources of government revenues from oil and gas operations, other taxes such as state equity and carried interest, VAT and other indirect taxes should be given due consideration and properly negotiated when drawing up petroleum agreements and properly managed after oil and gas exploitation activities commences.

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Answer-to-Question- 2

As noted in the background to this question intellectual property (IP) is important in the development of oil and gas projects but there are associated tax consequences which should be properly managed. In explain below the significance of tax planning in relation to IP and also give an indication of its treatment in some selected countries below.

1. The payment for the use of IP may qualify as royalties or management fees under the respective domestic laws or applicable tax treaties. In some countries royalties and/or management payments will qualify as a tax deductible expense but there may be some restrictions if the payment is to be made by a branch to the head office or another related office. It is therefore important to check to see if such restrictions exist so that it can be minimised or avoided.

Under PSC, unlike tax and concession regimes, IP costs may not qualify as cost oil and hence effectively, government does not directly bear a part of the cost. This is helpful in developing the model and projecting return on investments.

Another significance of tax planning to IP is that it helps in selecting which country(ies) should hold the IP. In some countries, income from IP may not be subject to significant income tax and it may be beneficially to locate the IP in such a jurisdiction provided that such payments are not subject to onerous withholding tax from the paying jurisdiction. This is because some countries impose higher withholding taxes when the IP payment is made to a tax haven.

Tax planning also enables us determine the appropriate transfer price and also helps one consider if the company can enter into an Advance Pricing Agreement(APAs)with the relevant tax authorities or authorities. It enables us to determine what method the tax authority or authorities will consider as acceptable - either the OECD pre-approved methods or alternative country-specific ones. Tax planning and arrangement will enable us know if cost plus margin method is acceptable for management fees or not or how the estimated market value should be determined for royalties payment purposes.

Furthermore tax planning will enable us determine whether royalties an/or management fees in respect of the IP should be determined as performance based (eg. a percentage of net revenues), or cost shared where more then one entity contributed in developing the IP. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators can be used as a guide for cost sharing arrangements if the country in which the oil and gas company operates considers that source as authoritative.

In respect of mergers and acquisition arrangements it ought to be determined if the IP should or can be acquired and at what amount. The associated price for the transfer and the associated capital gains tax determined.

2. I explain below the tax treatment of IP developed for the following countries:

a) **Switzerland**: Domiciliary, mixed or auxiliary companies in Switzerland perform most of their business activities (at least 80%)with commercial effects (such as IP) abroad and host administrative functions in Switzerland. Royalties from IPs licensed abroad qualifies as foreign-sourced income and the rules typically permit for amortisation of such costs for up to five years, and debt financing of the IP up to 70% of the fair market value of the IP.

The federal rate of Switzerland is 8.5%. Where a mixed company ruling is obtained about 5% to 30% of foreign-sourced income is subject to cantonal and commune tax which range between 1% to 4%. The combined tax rate form IP and management activities may be permitted in certain cantones and this may have a combined effective tax rate after allowable deductions of about 3%. This benefits encourage business to set-up in Switzerland, as a result of tax planning, although the European Union (EU) considers this as state aid contrary to the 1972 Agreement between the Union and Switzerland.

b) **Netherlands**: As a result of the Netherlands Innovation Box rules which applies under the Corporate Income Tax Act 1969, from January 2010, IP having patent rights or government R&D declaration has its tax base reduced by 80% resulting in an effective tax rate of 20%. An additional benefit is that IP losses can be deducted against standard rate profits thereby bring down related taxes.

Unlike the Switzerland case, the Netherlands Innovation Box rules have not been considered as a state aid by the EU. It is however important that there is commercial substance in that the

Netherlands entity should bear the risks and costs of the R&D and have sufficient personnel to manage the IP development process.

c) **Luxembourg**: IP such as copyrights and patents whether self-developed or acquired benefits from tax concessions under the Luxembourg Law of 21 December 2007, Section 50. The tax is based on gross revenue less allowable cots including amortisation and subject to tax of 5.93%.Losses may be fully deductible at the corporate tax rate and losses recouped when the rights are sold. There is not withholding tax on royalties and all this serves to make it an attractive destination for IP.

d) **United Kingdom (UK)**: A 130% of qualifying R&D expenditure is available in the UK under the Large Company Scheme as per the Corporate Tax Act 2009, Part 13, Chapter 5. Exploration and appraisal expenditure qualifies for 100% deduction for corporate tax. The R&D expenditure must relate to the company's current or future trade.

It is worthy of note that in the UK, time charging is the common method of charging for IP.

e) **Brazil:** IP technology innovation related incentives are available under the Law on Tax Incentives for Business R&D, Law 11196/05 in the form of between 60% to 80% qualifying as additional deductions. In addition, accelerated depreciation is available for research and innovation and a 50% reduction in excise tax imposed on relevant goods used for R&D purposes. Withholding tax is not applicable on remittances made abroad to register and maintain trademarks and patents.

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Answer-to-Question- 4

Shareholders invest primarily to make a decent (if not the most)return on their investments. Oil and gas companies in making investments will therefore have this in mind in optimising shareholder returns.

Typically a foreign country that seeks to carry on oil and gas operations in a host country may seek to do this by incorporating a company or registering a branch subject to the relevant regulatory issues in the host country. This has an impact in both the host and host country in terms of taxation as in some country the tax consequence on deductible items and repatriated profits differ for branches and subsidiaries.

In the home country the profits received may not be subject to tax either unilaterally (eg due to participation exemption rules) or under a tax treaty (using the exemption method). In some instances credit on underlying profits may be granted under the credit method.

In the home country, profits repatriated are typically not deductible for income tax purposes. There may therefore be incentives to minimise that tax in the host country within scope permitted by local laws such as deducibility of interest, management fees, royalties and other intercompany charges. It is recommend that the tax consultant in the home country reviews and confirms the appropriateness of the financial model and schedule built for the purposes of identifying what alternatives means of profit extraction methods can be used.

Other general matters that should be considered irrespective of the structure used before turning my attention to some specific matters relating to the type of structure are explained below.

The price at which group entities transaction can be used as a means of extracting profit. For instance if the tax rate in the country for the oil and gas operations are significantly higher, then the oil may be sold to a group company in a country with lower taxes. In addition, the fees that are charged to the local country may be higher. However there issues should be considered in the light of transfer pricing provisions in the respective countries, especially in the home country. Where possible, an Advanced Pricing Agreement (APA) may be entered into for improved certainty sake and where cross-border disputes arise the mutual agreement procedure can be explored if a tax treaty exist.

Now I turn my attention to specific issues that arise on the use a branch or a subsidiary.

Branches:

In some jurisdictions, management fees, royalties and interest payments made by a branch to a head office or related offices may not be allowed for income tax deduction purposes unless it is proven that this are recharges of third party cost. It is therefore recommended that appropriate document is available if charges are made in respect of such countries. Article 7 of the OECD Model mentions something similar.

Also the head office in deciding to use the branch structure note that liabilities of the branch could extent to it even if branch profits tax are not imposed in the home country.

In some countries branch profits tax may be higher than dividends tax and this is also an important issue to consider.

Loss in foreign branches may be an advantage as against the use of subsidiaries where cross-border group consolidation may not be available.

Subsidiaries:

Dividends which is usually not tax deductible will be subject to withholding tax at gross. It is therefore important that investments are made, if possible, from treaty countries.

Unlike branches it is unlikely that royalties, management fees and interest would be disallowed when such payments are paid for related companies as a means of profit extraction. However it is important to take note of transfer pricing issues. The appropriate transfer pricing method should be used in getting the acceptable range and the related documentation and filing requirements should be met.

For interest, thin capitalisation rules which may have a safe harbour limit of say 2:1 for debt to equity may be applicable. This ratio of debt to equity should be considered as in several countries the denied interest will still be subject to withholding tax in full.

In all cases withholding taxes on gross amount may apply and this should also be considered as an appropriate issues. Where tax treaty exists, charges should be made by related entities in treaty countries subject to substance issues such as staff and support.

In summary, although dividends and branch profit remittance are the major means of repatriating profits other profits extraction methods such as interest, management fees, royalties can be used. Transfer pricing and regulatory issues on the type of operating entities should also be considered and major issues for minimise likelihood of eroding shareholder returns.

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Answer-to-Question- 6

1) Interest are usually treated as deductible expenses in incurred for business purposes subject to some restrictions

Where loans are used to acquire assets, the interest on the loans will usually be available as a deduction, subject to thin capitalisation and transfer pricing rules, in the tax records of the acquirer especially for concession regime effective tax rate of the acquirer. For PSC regimes financing costs are usually excluded from cost oil.

In the case of shares, this may be more difficult, for example there may be restrictions where the related dividends are tax exempt under participation exemption rules.

2) where debt push down is allowed, the purchaser (typically an SPV)
may take a loan to acquire the target and then subsequently merge with that target and continue to take a deduction in respect of the loan. If that debt is a third party debt the issues of thin capitalisation may not arise and the issue of transfer pricing may not be a concern assuming there was not back-to-back arrangements. Such arrangements will work in jurisdictions where tax consolidation is permitted.

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Answer-to-Question- 8

Foreign investment in oil and gas operations may be doing using group financing. However there be restrictions of this in the laws of the host country through transfer pricing rules and thin capitalisation.

1 Thin capitalisation rules limit the interest deductions imposed where the debt granted by a related company to a local company is considered as excessive in relation to the equity of the local company. This may call for changing the capital structure by introducing third party loans into the structure to reduce the related party loans.

Thin capitalisation rules may be defined expressly as safe harbour limits of say debt:equity of 3:1, a function of company's earnings before interest, taxes, depreciation amortisation (EBITA) or general transfer pricing rules.

The different ways in which thin capitalisation may introduce limitations for oil and gas companies and their tax effects include
reclassifying those "excess loans" as equity and disallow interest deductions. In some countries this excess interest may be carried forward while in others it is permanently disallowed thereby increasing the effective tax rate.

2)Possible ways of planning to bypass thin capitalisation restrictions include

i) using operating leases and/or sale and lease back transactions. This will avoid a situation where the local company borrows to acquire assets and interest is denied on those loans.

ii) debt factoring can also be considered so that the receivables of the local company is quickly recovered to an extent so there will be less need for loans from the other group companies.

iii) parent company increase the amount of equity up the threshold level.

iv) unless restricted by local laws, consider back-to-back loans.

v) use of guarantee fees arrangement which is likely to be treated as a deductible expense.

vi) higher interest on loans for loans within the limit but subject to transfer pricing rules.

vii) asset for equity swap can also be considered.

viii) payment for financial treasury management services provided by the parent or a related party.