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SUGGESTED SOLUTIONS

PART A

Question 1

State Equity and Carried Interests

Contracts with governments may provide for state equity, which refers to the government share of the oil and gas development. This right to an interest in the project is generally combined with other taxation methods:

1) State equity may be in the form of full working interest, where government equity is paid up on commercial terms. State equity may be made on concessional terms, where the government acquires its equity share at a below-market price. The government may have an option to acquire an interest if the project is successful – after commercial discovery has been made.
2) The government may have a carried interest, in which the government's share of explorations and development expenditure is paid by the oil and gas company. The government may pay for its equity share and share of expenses from the proceeds of oil or gas production if the project proceeds to the production stage. The oil and gas company carries the risk of not being reimbursed for the expenses if the project does not result in significant production.
3) State equity may be acquired in return for a reduced tax liability on the oil and gas company. State equity may also be acquired for a non-cash contribution, such as government provision of project infrastructure, such as harbour facilities, roads and pipelines.
4) State equity is quite significant for the financial model of an oil and gas project. The structure of state equity is not a tax, sharing of profit oil, or a royalty. However, the state may effectively obtain an additional large proportion of profits, for example by exercising an option to acquire a 25% share of a project.
5) State equity is an issue with new projects and for mergers and acquisitions, where the state equity, or the option for the government to acquire state equity, will significantly affect the oil and gas company's net return from the investment.

Indirect Taxes and VAT

Value Added Tax (VAT) is imposed in many countries on the value of a company's sales, with the company allowed a credit for VAT paid on their purchase. VAT therefore applies to the value added by each stage from production to final sale.

The export of oil and gas may be 'zero rated' for VAT purposes. The result is that VAT is not chargeable on the export sale, however the company is entitled to a refund of the VAT paid on its related purchase. Zero rating may then result in a credit refund issue.

The oil and gas company may be applying for refunds, as it has paid VAT on its purchases, but does not charge VAT on its sale where export sales are zero rated. The issue is whether refunds are allowed, are provided promptly, or there are substantial delays.

There may also be an issue that VAT refunds may be restricted to the related joint venture, rather than made available to the investing companies.

Tax regimes and PSCs may therefore provide specific exemptions from VAT to avoid this credit refund issue. This may be extended to local suppliers to upstream oil and gas companies.

Alternative methods of indirect taxation include the gross turnover taxes applied in many states in the United States. These are essentially single stage taxes on the final sale to the consumer.

Countries may also impose significant customs duties on importation of equipment for exploration and production. Several countries allow specific exemption under PSCs or tax regimes from indirect taxes such as VAT where equipment used in oil and gas activities is subsequently exported after use. Examples: The Brazilian Repetro regime, and the Indonesian Import duty.

Customs duties are a significant issue for the importation of oil and gas, and a related issue is whether there are exemptions from customs duty under international agreements. Examples: the related exemptions between Canada, Mexico and the United States under the North American Free Trade Agreement.

Related issues include whether crude oil and natural gas qualify as sources in a NAFTA country under NAFTA rules of origin. For example, when oil and gas companies blend crude oil with condensates or diluents from non-NAFTA states to transport the oil by pipelines, or blend natural gas with gas origination in non-NAFTA states.

Question 2

Importance of tax planning and different agreements related to holding of IP

IP and intangible assets related to oil and gas will normally include drilling technology, software and other IT, geological and geophysical data or analysis, seismic surveys and H&S manuals and procedures. These services/information is normally provided by third parties of group companies and leading to the payment of royalties of management fees to the provider of the IP. This is more important for oil and gas service companies providing technical services to oil and gas exploration companies.

The tax planning in this area is of extreme importance given the big amounts paid in this type of service, information or data by oil and gas companies. Possible optimizations of the payments streams and jurisdictions used will reduce the amount of tax due on these cross border payments and incomes.

This tax planning may be done by effectively using the double tax treaties entered into by the host State to identify any efficient jurisdictions for this type of royalty of management fee payments. Where appropriate, the use of a IP holding company in a tax effective Country can significantly reduce the amount of that paid by the receiving group entity providing the service or IP. For payment of management fees the use a more efficient tax jurisdiction can lead to lower withholding payments in the host State.

In either case it is important to note that in transactions between related entities it is always necessary to make sure the companies used have the right level of substance and management and that transfer pricing rules and arm's length principle are respected to ensure the right level of costs and payments.

Oil and gas IP may be held or charged through several different structures as per example cost sharing agreements or cost contribution agreements where the cost of developing new IP is shared between the future users of said IP or technology and cost is allocated on the basis of the anticipated benefits for the recipient of the IP. Other possibility of time charging the time spent by several experience professional in the work developed for a specific project. In each situation attention should be paid to the tax impact of the payments in terms of the deductibility of the cost and withholding tax eventually due on payment

The oil and gas agreement also plays a big role when deciding the optimal structure as Production Sharing Contracts generally do not allow for the cost recovery of royalties but may be deductible under Concession Agreements if tax regime jurisdictions. Thus, the use of time charging or cost sharing agreements will work better with PSCs regimes or field partnerships.

Tax treatment of IP under the most commonly used jurisdictions

Switzerland

In this jurisdiction there is specific type of auxiliary companies for provision of business activities abroad keeping the administrative function in the Country (including IP and other assets management). As a general rule there is a requirement for a high percentage of the income and expenses to be generated outside of Switzerland. A depreciation and amortization of the licensed IP is possible over a five year of shorter period. The combined effective tax rate including communal and federal tax plus allowable deductions may be reduced down to 3% through the use of a mixed tax ruling.

Netherlands

The Netherlands has introduced an innovation box regime for patented rights or possess a related R&D Government declaration. If the regime is applicable the tax base can be reduced by a very significant percentage and achieve an effective tax rate of around 5% assuming sufficient commercial substance is put in place.

Luxembourg

The applicable regime in this jurisdiction applies to software, copyrights, patents, trademarks and designs of models which can be acquired and self-developed IP. Assuming the requirements are met and low effective tax rate can be achieved through an exemption of a high percentage of IP profits. This regime also provides for an exemption from withholding taxes on royalties and a deemed deduction for used in-house.

United Kingdom

The UK offers tax relief to large companies through an uplift of the qualifying R&D expenditure. To benefit from this regime the R&D project needs to have the objective of constituting an advance in overall knowledge or capability in a field of science or technology or resolve scientific or technological uncertainty. The R&D must also be related to the company's normal trade or to start based on the developed R&D results. Exploration and Appraisal directly R&D expenditure does not qualify for this regime.

Brazil

This jurisdiction also offers an uplift on expenditures related to technologic innovation and accelerated depreciation of assets acquired for use for the technological research. Other benefits granted by Brazil to IP development and holding include exemption from withholding taxes on payments abroad related to registration and maintenance of trademarks and patents and reducing of normally applicable indirect taxation on goods used for the R&D.

PART B

Question 3

The analysis includes the structures to obtain interest deductions, generally known as ‘debt push down’, and the issue of the limitation on interest deduction under most PSA regimes.

There are opportunities relating to depreciation deductions in an acquisition, particularly to allocate a greater part of the purchase price of the acquisition to the value of depreciable asset, generally known as ‘asset step up’ to increase future depreciation deductions.

Tax losses may be a significant issue, particularly where there are accrued exploration and development expenses of oil and gas fields.

The seller may prefer to sell shares, however as this may be exempted from tax under ‘participation exemption’ provision operating in many EU countries. A share transaction requires greater due diligence as the buyer will acquire the company together with all its liabilities.

Farm-out/farm-in arrangements may be used, where the investor agrees to share future expenses in return for a share of the oil and gas development. These arrangements may not be taxable if the consideration is uncertain (for example the costs of developing an oil or gas well are not known) whereas cash payments for the farm-in are generally taxable.

Taxation issues relating to sale and purchase agreements include whether the seller provides effective warranties and indemnities relating to tax. These clauses may determine whether the buyer or seller will pay the potential tax on the acquisition, whether the seller is responsible for the value of any stated tax losses, and which party is responsible for tax in the period after executing the contract and the final closing date.

Whether tax indemnities have a financial or time limit, and the indemnities should be provided by the seller’s ultimate parent company, rather than a holding company which may have limited assets.

The tax due diligence process is analysed, including access to physical or online data rooms provided by the seller, information that should be requested by the buyer, the tax team’s input to financial modelling for the investment, materiality levels for reporting tax issue to the acquisition team, and the effects of the acquisition on the accounts and deferred tax balances.

Question 4

The main issue to consider in the repatriation of profits obtained from an oil and gas project is the tax which will be due in the parent company's jurisdiction. It is expected that any profits obtained from exploitation of a hydrocarbons license in a host State will always be subject to taxation in the host State, which is the owner of the resources, and this will vary depending on the type of agreement and tax regime put in place by the host State. Thus, our first point of focus should be to guarantee that the profits are not then subject to an additional layer of taxation at the jurisdiction where the parent company or head office is located.

The tax advisor should also understand any specific requirements the laws of the host State may have which are applicable to companies involved in the oil and gas activity. Some countries require the holder of a license to establish a subsidiary for different reasons but mainly because of risk and responsibility management. In this case the use of a different structure will not be an option and we should plan accordingly. For the same reasons the oil and gas company may also have a preference for a branch which will be an easier structure to manage internally.

An analysis of the applicable oil and gas agreement (either a license concession agreement or PSC) to check whether the agreed tax clauses of the contract include any specific exemption on the repatriation of profits that can supersede any existing domestic legislation. It should be noted that for this to be a possibility it is necessary that the agreement has at the least the same legal strength than the legislation it is superseding. In most case this means the contract or agreement should be ratified by Parliament.

One other aspect to be considered is potential disinvestment in the project that may occur in the future. Part of the profit repatriation analysis should also include the potential farm-down or farm-out of the license. In this case any profits or goodwill obtained with the project will be transferred to the group company or head office. Attention should be paid to any capital gains taxation provisions and whether there is a difference between alternative structures which can be used (e.g. the laws may subject to capital gains tax the sale of the license but not the sale of the shares of a subsidiary holding the license).

The possible alternative structures are the use of either a local company (subsidiary) or the use of a branch of a non-resident company. These alternative structures have different tax treatments on repatriation of profit that should be considered before deciding on the structure. Beginning with the use of a subsidiary the attention should be turned to the ways in which profit obtained by the company may be transferred to its shareholder. This will normally be by way of a dividend payment or any other payments due to the shareholder for the management of group loans. The important issue to consider will be whether the host State has any dividend withholding taxes which may increase the Government take in the project. The rules of the shareholder jurisdiction should be considered to guarantee that the dividend payments received are not subject to any additional taxation at that level by the application of double taxation relief provisions, participation exemption regimes or tax treaties. When more than one license or agreement is held by the company an analysis of any possible ring fencing limitations or group relief provisions is necessary to ensure the best tax outcome.

Branches are only an extension of the group company in the host Country and it is not a separate legal entity from its head office. The local branches are "fictions" created to allow the taxation of activities linked to the State where the branch is registered. The branch will, as a general rule, have a separate set of accounts to ensure the taxable profit is calculated correctly in the host State. Main issue with the use of the branch is that because the home office and branch are the same legal entity there is no tax applicable to the transfer or funds between the two, meaning that profits could be repatriated without any additional taxation at the host State. There are however exceptions where the host State apply branch remittance taxes to these transfers giving them similar treatment to dividend payments. On the other side of the coin, the rules applicable to tax treatment of branch profits in the group company jurisdiction should be analysed to guarantee there is no double taxation or even additional taxation. There are normally two ways in which branch profit may be treated, it can be subject to tax together with the taxable profits of the home office and a credit may be given for tax already paid by the branch in the host State. In this case, where the tax rate in the home State is higher than in the host State additional tax may be due and the branch is not a recommended structure. The other way is for the home State to grant an exemption of any branch profits obtained by foreign branches. This may be either an election or mandatory depending on the State and is normally subject to the anti-abuse provisions which require the branch profits to be subject to tax in the host State.

Another discerning factor between subsidiaries and branches is that there should not normally be any payments for services or finance interest within the same entity. However in the case of branches there is the possibility of having an allocation of costs by the head office to the branch. This possibility may reduce the amount of taxable income in the host State depending on the allocated amounts. The allocation amounts should be considered in light of transfer pricing rules. The problem in the allocation of costs is that in most situations the deductibility of these allocations is heavily limited to a specific percentage or amount by the host State and may not be as efficient as having payments between two separate legal entities which is as a general rule fully deductible, assuming transfer pricing rules and thin capitalisation provisions are considered.

Potential temporary or permanent tax losses situation should also be a factor in the analysis of the best structure for repatriation. In some situations home office jurisdictions allow for the deduction of temporary and final losses obtained by foreign branches which in case the project is unsuccessful may be a good way to efficiently reduce the cash amount lost by the company. It some cases the possibility of considering foreign subsidiary accumulated losses is much rarer which may lead to an advantage of the branch structure depending on the expectations or risk for the project.

PART C

Question 5

Part 1

The United Kingdom allows an indefinite tax loss carry-forward, and a one year carry-back of losses.

Transfer pricing rules applies to international transactions and transactions within the United Kingdom.

The ring fence provisions provide that onshore losses may not offset offshore profits.

There is a first year capital allowance of 100% for capital expenditure from the ring fenced trade. The allowances do not apply to exploration costs, however the research and development allowance at 100% may apply.

The consolidation, known as group relief, is allowed for corporation tax and supplementary charge purposes between companies with 75% common ownership.

The corporation tax rules can limit interest deductions using transfer pricing approach requiring 'arm's length' terms.

Interest deductions may also be limited under world-wide debt cap rules, but these do not apply to ring-fenced companies.

Part 2

The Ring Fence Corporation Tax applies to petroleum companies in the same way that it applies to all companies except with the addition of a ring fence – the ring fence covers a company's taxable profits derived from oil and gas extraction in the UK and the UKCS. Companies may not reduce their ring fence profits by losses incurred from their other activities or by excessive interest payments. The current rate of tax on ring fence profits is 30% (as opposed to an existing 20% mainstream corporation tax). A first year allowance is available up to 100% of all capital expenditure.

Supplementary Charge (SC) applies to ring fence profits accruing from 17 April 2002. The current rate of SC is 10% which has been reduced from 20% with effect from 1 January 2016. SC applies on a company's ring fence profits but no deductions are permitted for finance costs. The Supplementary Charge, however, may be reduced by various allowances such as the investment allowance, cluster area allowance or onshore allowance.

Finally, PRT, a field based tax, introduced under the Oil Taxation Act 1975 at 75% rate. PRT was a charged on "super-profits" arising from the exploitation of oil and gas in the UK and the UK's continental shelf. PRT is charged by reference to individual oil and gas fields, so the costs related to developing and running one field cannot be set off against the profits generated by another field. It is a charged on profits arising from oil and gas production from individual fields which were given development consent before 16 March 1993 – PRT was abolished for all fields approved for development thereafter and it was reduced to 50% for paying fields. The rate of PRT is 0%, having previously been reduced from 50% to 35% in 2015. PRT is deductible as an expense for the purposes of calculating Ring Fence Corporation Tax and the Supplementary Charge.

Question 6

Part 1

Interest deductions are generally allowed to a company for the purchase of assets under tax and concession regimes, as the assets will generate taxable profits. It may be more difficult to obtain interest deductions to purchase shares in a target company – there may be restrictions where the related dividends are tax exempt under participation exemption provisions.

Interest deductions may be used against profits of the acquired company if the country allows tax grouping or consolidation.

The effective use of interest deductions in PSC regimes is more difficult. The PSC itself will generally exclude financing costs as allowable costs in determining cost oil. The issue may then be whether interest deductions on debt to acquire licence interests subject to PSC regimes can be made elsewhere in the multinational group – at a parent company level.

A number of countries have thin capitalisation provisions which restrict interest deduction on related party debt.

The debt push down issue more frequently related to the placing of third party debt within a multinational group, such as borrowing from banks, and in many countries interest on this debt is not subject to thin capitalisation provisions.

Part 2

The objective here is to use a debt push down structure to utilise interest deductions in Target Company to offset that company's profit.

Tax Analysis

Purchaser Company may obtain a tax deduction in its own country. However, it may not be able to effectively use the deductions if it does not have significant taxable income. The ability to use tax deductions is generally known as 'tax capacity'.

Purchaser Companies use a new company in the target country, usually called a special purpose vehicle (SPV). The SPV then purchases Target Company, or the oil and gas assets, on behalf of the purchaser Company.

If the target company is acquired then tax consolidation is generally needed to transfer tax losses arising from interest deductions in the SPV to reduce tax in Target Company. It is necessary that the related country has some form of tax consolidation.

Consolidations

Care is needed with the timing of adding debt and related interest deductions. An upstream oil and gas target company may be in exploration or early production stages, with large carry-forward losses. There may be an advantages in increasing related party debt at a later stage when the target company is profitable, and when the deductions can therefore be utilised.

Question 7

Part 1

The host Government may increase the corporate income tax rate or special tax rate applicable to the taxable income of the project.

It can also introduce new supplementary charges or increase the charges that already apply to the oil revenue (e.g. United Kingdom).

It can delay any VAT refunds due to the company or disregard any utilizable tax losses accumulated by the company in the initial years of the project.

It can introduce new restrictions or customs charges to the import and export of equipment used in the exploration and production (e.g. Ghana).

It can introduce new withholding taxes on income streams (e.g. interest payments, branch remittance tax or dividends).

Part 2

The oil and gas company can include stabilization clauses in the contract agreed with the host Government of national oil company. Stabilization clauses function as a protection tool of the long term investment made in a Country and have the purpose of "freezing" the legal and tax regime (applicable to the oil and gas project) in force at the time the contract was entered into between the parties. With this clause the parties ensure that future changes to the legislation would not affect the project either by including additional duties or by increasing or decreasing the tax which would be due from the sale of oil or gas.

The company may also rely on arbitration clauses to start an international arbitration case under one of the recognized arbitration forums for a breach of contract. After the start of the procedure each side will nominate their experts and present their arguments before an international court chosen by the parties. In case the company obtains a favourable discussion the same should as a general rule be enforceable against the host State.

Finally the company can rely upon existing Bilateral Investment Treaties signed between States to protect companies from each of the signatory Governments against harmful measures to the foreign investor. The bilateral investment treaties include, as a general rule, clauses to protect the foreign investor against expropriation without compensation, unfair inequitable treatment and free transfer of funds. These clauses can be used by the oil and gas companies to argue there was a breach of the treaty when a Government unilaterally increased the tax rate or created any unlawful tax restrictions to a project.

Example cases include:

1) RosInvest Co UK Ltd v Russia Federation: This case concerned the bilateral investment treaty between UK and Russia and a company called Yokus. The company was being targeted by arbitrary tax increases that created and increase to 54% from the normal 30% Corporate Income Tax rate. The Tribunal concluded in favour of the company arguing the tax rate increases were arbitrary and confiscatory.

2) The Duke Energy v Peru: The case concerned a situation where no new taxes or duties had been introduced but a change in the interpretation of tax laws by the tax authorities had created a similar effect of increasing the tax on the project. The discussion of the Tribunal was around the fact whether a tax stabilization clause could still apply in a situation where the change in tax treatment did not arise from the introduction of new laws but by changing the interpretation given to the old laws. The Tribunal found in favour of the company that the stabilization clause could still apply specially in situation where the new interpretation was patently unreasonable.

3) EnCana Corpn v Republic of Ecuador: This concerned the bilateral investment treaty signed between Ecuador and Canada. The company argued that by denying to refund any VAT paid to the State, the Government was indirectly expropriating the company of its rights in Ecuador. In this case the Tribunal decided in favour of the host Government by deciding that the indirect expropriation criteria could only be used in situation of extremely punitive or arbitrary amounts confiscated by the State.

4) Occidental Exploration and Production Company v Republic of Ecuador: This case concerned the bilateral investment treaty between Ecuador and the United States. The tax authorities changed their tax policy pertaining VAT refunds. The tax authorities changed their stance by denying any additional VAT reimbursements and requesting the company to return any previously VAT reimbursed previously by the Government by arguing the VAT paid was already considered in the contract between the company and Ecuador. The tribunal decided in favour of the company by arguing the chance of policy discriminated the company against other exporters and sectors.

Question 8

Part 1

The thin capitalisation restrictions are domestic provisions introduced by different States to avoid a company with a small amount of capital or equity to contract big amounts of debt from a group or related company and accumulate tax deductible interest expense which reduce the amount of tax collected by that State. The principle behind the restriction is that under normal market rules a accompany with no assets should not be able to secure large amounts of debt from third parties and therefore the use of company loans may be being used only to obtain unlawful reduction of the tax normally due in the host jurisdiction. The effect of the thin capitalisation provisions applying is that the company will see denied the tax deduction for any interest expense which exceeds a certain threshold or does not comply with the requirements of the provisions. As a general rule any disallowed interest can be carried forward for the following years.

In some countries the rules may be extended to third parties loans where there is an influence of group companies in the obtaining of said loan. The more common examples of this is the granting of a guarantee by a parent group company or a back to back loan.

Many countries use a debt to equity ratio to determine what would be an acceptable amount of debt under the thin capitalisation provisions. This ratio is normally around the 3:1 mark but it can be higher or lower depending on the jurisdiction.

Some countries complement their thin capitalisation rules with an earning stripping rule. In this case a lower debt to equity ratio (e.g. 1.5:1) is put in place where the company receiving the interest payment is not subject to tax in the same Country as the company paying the interest (e.g. USA).

Other companies use the transfer pricing provisions as criteria for the analysis of acceptable amounts of debts. Where the amount of debt exceeds what would be authorised to an independent party the corresponding interest expense will be disallowed as a tax deduction (e.g. UK).

In some countries the thin capitalisation legislation allows the company obtaining the loan and the tax authorities to enter into an advance agreement on the acceptable amounts of debt either through a specific advance thin capitalisation agreement or through an Advance Pricing Agreement.

The thin capitalisation analysis can also in some cases consider the worldwide situation of the group by comparing the amount of debt obtained by all the companies in a certain jurisdiction exceeds a determined percentage of the overall group worldwide gross external debt and disallows any interest expense exceeding this percentage (e.g UK).

Other criteria used by some jurisdictions to kick-in thin capitalisation provisions is the debt to EBITDA (earnings before interest, tax, depreciation and amortization) ratio or the debt to assets ratio. In this countries the net interest expenditure in excess of a determined percentage of a company's EBITDA or total assets will be disallowed. This can apply to third parties or related companies loans (e.g. Germany and Denmark).

Part 2

Potential alternative structures for funding outside the thin capitalisation provisions include:

- Sale and lease back agreements where the group company buys an asset from its subsidiary and then leases the asset back to the seller. This is normally qualified as an operating lease which as a general rule will not be considered debt under the thin capitalisation provisions.
- Debt factoring where the subsidiary sells its trade receivables for future payments or doubtful debts at a discount considering its book value given that it will receive the

payment immediately. It is important this operation follows the transfer pricing provisions and market conditions which would apply between independent parties.

- A back to back loan where the group company intervenes in the relationship between the bank and the subsidiary by guaranteeing the loan through a deposit made with the same bank in another jurisdiction or through the granting of parent company guarantees. In some situations a fee may be charged to the subsidiary which could also be tax deductible in the host jurisdiction.
- The group company may increase the equity portion of its subsidiary either through cash or assets contributions so that it can comply with any debt to equity ratios applicable under the thin capitalisation provisions.
- The parent company and subsidiary may agree on fees due for financial services as cash pooling treasury management, foreign spot transactions, currency purchase agreements, swap transactions which will not as general rule be qualified as interest expense. However, some jurisdictions may include these fees in the definition of interest for thin capitalisation purposes.
- The group company may provide a smaller loan at a bigger interest rate assuming the transfer pricing principles allow for this rate considering the market and risk aspect of the loan. This is normally something allowed for oil and gas projects considering the high level of risk of the initial investment in exploration of hydrocarbons.