Global oil & gas tax newsletter
Views from around the world

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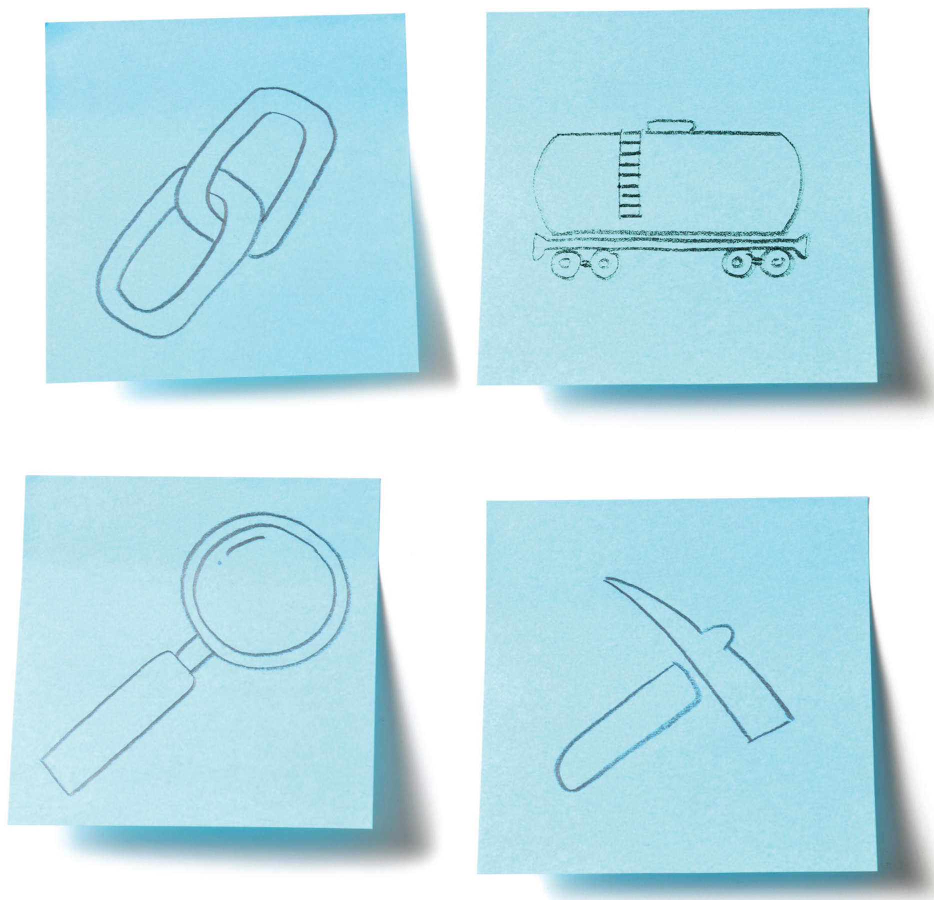
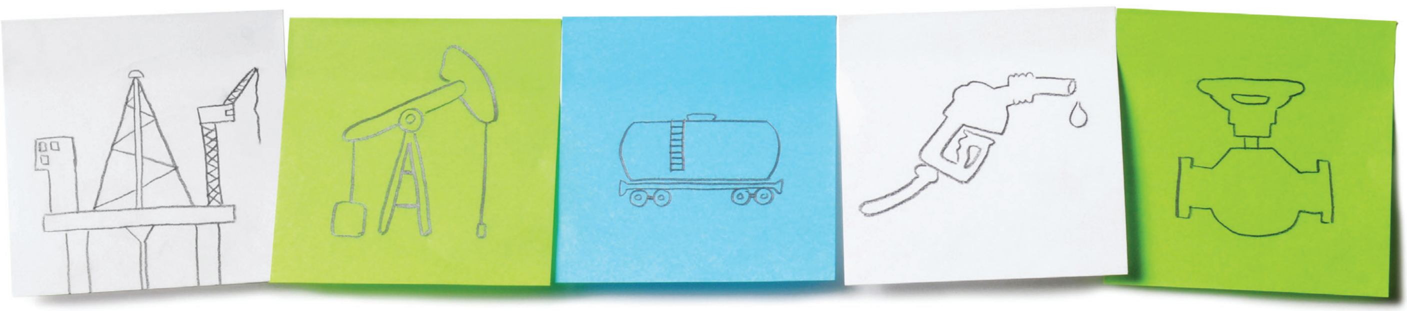


October 2013

Spotlight on the business of oil: Supply chain, substance, and tax implications of cross-border transactions



New business reality

The 2008 global recession had different and opposing effects on governments and Multinational Corporations (Multinationals). Multinationals realized the importance of geographic diversification and started to expand their global presence while trying to maintain control over costs. The goal of geographic diversification is generally in line with a Multinational's goal of sustaining earnings growth by targeting high growth potential areas such as the Asia Pacific and BRIC (i.e., Brazil, Russia, India, and China) regions. Expansion into new markets requires Multinationals to reassess their revenue, cost, and value drivers especially the expanded supply chains needed to serve new customers.

Conversely, governments, strapped for income to meet rising demands for social benefits and seeking to avoid costly financing in the bonds markets, are reassessing their tax rules in pursuit of additional sources of revenue. As a result, large Multinationals including those operating in oil and gas are starting to incur increasing tax compliance costs and may be facing escalating tax audit risks.

… many Multinationals are establishing a Principal Operating Company (POC) to provide a cohesive framework for business model changes.

In addition to tax and transfer pricing difficulties, Multinationals operating in the oil and gas sector have one of the most complex supply chains of any industry. This complexity is driven by the need to provide significant amounts of machinery, equipment, and technical services to far flung locations, the high risks to both employees and the environment when something goes wrong, and the significant dollars lost from poor execution and non-productive time at the well site. These challenges lead oil and gas Multinationals to seek efficiencies and improved turnaround times whenever possible.

Consolidating, centralizing, standardizing, and streamlining functions, operations and value drivers within the supply chain and logistic organization, while initially disruptive, typically allow companies to improve quality and accountability, reduce costs, manage operational risk, and better track performance metrics. Some of the common business model changes within the oil and gas industry include: centralized management and development of intellectual property, rationalized supply chain, consolidated procurement functions, standardized operating processes, streamlined manufacturing processes, centralized asset ownership, and centralized sales organizations. These business changes may be evolutionary or part of an overarching strategic initiative. To support those changes, many Multinationals are establishing a Principal Operating Company (POC) to provide a cohesive framework for business model changes.

Oil and gas companies are expected to continue to centralize functions for operational and competitive reasons …

Structurally, the POC controls the performance of the centralized functions and bears the corresponding risks. The different types of POCs observed in the oil and gas industry are briefly discussed at a later stage of this article.

Locating a POC in a business friendly and tax efficient jurisdiction may allow a company to reduce its costs if the POC has a substantive and economic claim to residual profits in its transactions with its local operating affiliates. Since this type of planning is driven by business and operationally changes we refer to such planning as Business Model Optimization (BMO).

Oil and gas companies are expected to continue to centralize functions for operational and competitive reasons, and tax authorities may step up their scrutiny of cross border sharing of profits. These dynamics may inevitably lead to higher tax compliance costs and increased audit risk for Multinationals. It is therefore important that BMO planning be rooted in operational reality and for the cross border intercompany transactions of the POC to be reflective of economic substance.

Regulatory landscape

As outlined above, tax authorities and regulatory bodies will likely monitor Multinationals' use of transfer pricing and planning structures (such as POCs) and have drafted relevant regulations and guidance. Most recently, the Organisation of Economic Co-operation and Development (OECD) has been actively issuing a number of reports, updated guidance, and white papers addressing transfer pricing of intangible property and what the OECD refers to as Base Erosion and Profit Shifting (BEPS).

In 2013, the OECD issued the "Base Erosion and Profit Shifting" report[1] and action plan[2] that identifies and discusses a number of areas in which the OECD believes additional or new legislation is needed in the current body of law governing taxes paid by Multinationals.

The relevant topics raised by the BEPS project for purposes of our discussion relate to the structure and pricing of intercompany transactions. The BEPS project suggests more alignment between transfer pricing outcomes and value creation when transferring intangibles, functions, and risks among affiliates.

Considering value creation or value drivers when pricing intercompany transactions is not a new concept and is the foundation of sound transfer pricing analysis. The OECD's renewed emphasis on value creation, however, highlights the importance of substance within a POC and is a response to what may be viewed as "tax" motivated structuring.

The BEPS action plan recommendations in this context are intended to ensure that a POC performs and/or controls the important functions in intercompany transactions and incurs the corresponding risks in relation to the said functions. The intensity of functions and risks embedded within a POC will vary based on the type of operating model a Multinational employs, but the OECD guidance suggests that the act of bearing risks alone, without associated functions, is less compensable than some Multinationals have proposed.

The BEPS action plan also calls for additional guidance on intercompany transfers of intangible property. The OECD's Draft Chapter VI, published on the heels of the BEPS report, is responsive to this request and also emphasizes the importance of value creation in the context of such transfers and the use of various transfer pricing and valuation methodologies.

Principal Operating Companies in the oil and gas industry

The OECD BEPS action plan motivates the use of POCs as follows:

"Globalisation has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers."

The OECD's renewed emphasis on value creation highlights the importance of substance within a POC and is a response to what may be viewed as "tax" motivated structuring.

1 "Addressing Base Erosion and Profit Shifting."

2 "Action Plan on Base Erosion and Profit Shifting."

As discussed above, POCs are implemented by oil and gas companies to centralize, standardize, and harmonize operating procedures and approaches to customers, and to consolidate, control, and further develop significant value drivers, functions, and risk management policies. The concentration of these activities impacts and enhances operational efficiency and can drive bottom line profits. Locating a POC (i.e., the value drivers or value created activities) in a tax efficient jurisdiction may attract low taxed residual profits through the POC's intercompany transactions with its foreign affiliates.

Exploration and Production (E&P) Multinationals have historically utilized POCs to centralize main value drivers such as: Intellectual Property (IP), procurement, asset, and risk management activities. E&P companies however, are subject to gross income type taxes, higher tax rates, limitation on deductions, or outright deemed profit taxation regimes in a large number of the countries in which they operate. These differing taxing regimes may limit the effectiveness of BMO planning and limit the ability of the POCs to consistently realize residual profits in intercompany transactions.

The business models and regulatory environments of companies operating in the oil and gas services and downstream sectors make them better candidates for BMO planning. Some of the BMO structures implemented for service companies include:

- Intellectual Property Principal: centralizing the ownership and development of a company's intellectual property. The POC undertakes activities relating to budgeting, funding, approving, and protecting the intellectual property used by the Multinational in its operations.

- Product Supply Chain Principal: centralizing ownership and development of manufacturing processes, negotiations and signing of supplier and contract manufacturing contracts, ownership and development of supplier and contract manufacturing quality control processes, conducting demand planning, etc.

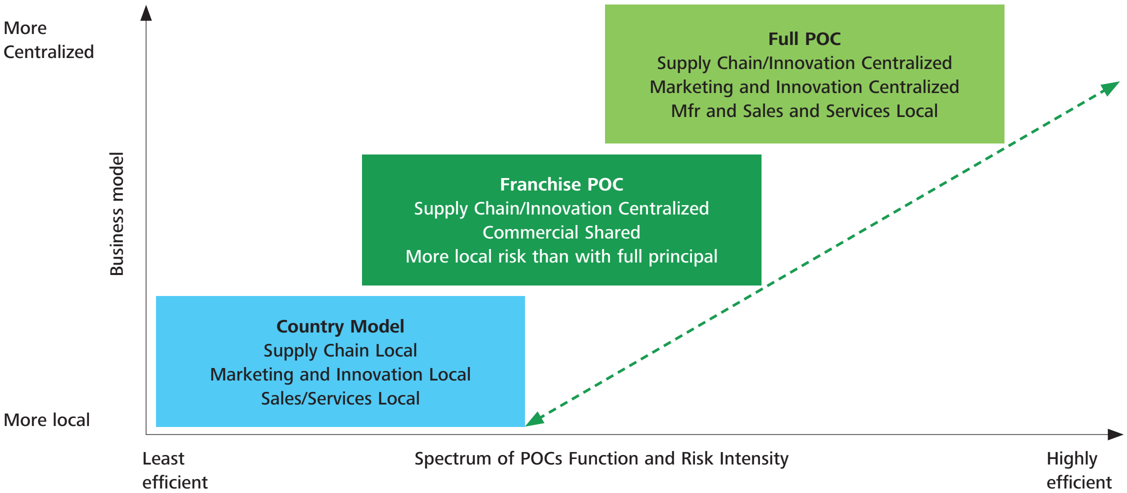
- Operating Asset Principal: centralizing the ownership of assets utilized by the Multinational's operating entities such as drilling rigs and equipment, controlling capital expenditure, asset utilization and repairs, etc.

- Sales and Marketing Principal: centralizing the sales and marketing activities relating to trading of refined products, ownership and development of proprietary trading platforms, ownership and development of regional market knowledge, etc.

The above listed POC structures can be implemented with varying levels of functional and risk intensity based on the business requirements and operational flexibility of the Multinational's local affiliates. Based on the functional and risk intensity level within the POC, the spectrum of Multinational's business models can be depicted in the graph opposite.

… POCs are implemented by oil and gas companies to centralize, standardize, and harmonize operating procedures and approaches to customers, and to consolidate, control, and further develop significant value drivers, functions, and risk management policies.

Fig 1. Function and Risk Intensity Spectrum



… regular monitoring is required to confirm that the POC continues to operate as a central entrepreneur managing all relevant strategic functions and risks.

Substance in POCs

Given the recent regulatory developments, having appropriate substance in a POC is more essential than ever. It is not enough for a POC to contractually own the centralized value drivers and bear the associated risk, but it is also critical that the appropriate personnel performing these functions are located within the POC's jurisdiction to manage the centralized functions, assets, and risks. In other words, enough people, assets, and risks have to exist in the POC for it to act as a central entrepreneur for the relevant business segment, region, or transactions in which it is involved.

A POC undertaking only approval activities in relation to the Multinational's value drivers will not be able to justify earning residual profits from intercompany transactions. A POC needs to also perform the functions leading up to the said approvals.

After the initial setup of the POC, regular monitoring is required to confirm that the POC continues to operate as a central entrepreneur managing all relevant strategic functions and risks. Analyses of the effects of subsequent "lean initiatives" initiated by Multinationals should be performed to determine that such initiatives do not dilute the POC's substance.

Implementing sustainable and supportable BMO planning

Deloitte's approach to designing and assisting clients in their implementation of POCs is based on the Multinational's operational business model and, assuming proper structure, tracking, and maintenance, results in benefits supported by the value drivers owned, managed, developed, and used by the POC.

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The BEPS action plan highlights the changing environment of the OECD (and likely renewed focus of local governments) and therefore highlights the importance of careful design and consistent execution of the POC structure.

Deloitte's approach is based on four work streams briefly discussed as follows (commonly referred to as the "Four R's"):

- Realign for Business Transformation:
  - Summarize current functions and organization prior to developing POC model alternatives to provide a common understanding of strategic goals, current functions, and processes.
  - Outline how the business may operate in the future in terms of business processes, transaction flows, legal entity organization and organizational design.
- Reconfigure IT Systems:
  - Analyze changes needed to company's IT Systems to transition to the potential POC models.
  - Provide a roadmap for the transition to the new IT configuration.
  - Conduct workshops and meetings with company's personnel to discuss the POC implementation and analyze the IT Systems impact.
- Ready Human Resources:
  - Communicate the initial POC relocation list to and confirm with key Stakeholders.
  - Prepare the incremental HR cost estimate with respect to the initial POC relocation list.
- Reorganize Legal, Finance and Tax Structures:
  - Analyze the primary U.S. and Non-U.S. tax technical issues, including:
    - Analyze local country tax impact of the transformation.
    - Perform POC location analysis.
    - Analyze potential VAT and Customs issues.
    - Preliminary analysis of the future state transfer pricing model between the POC and local entities.
    - Analyze Permanent Establishment risks in the relevant countries.
    - Analyze Subpart F impact, if any, under the new POC structure.
    - Consider Treasury and repatriation strategy with respect to conversion to the POC model.
    - Withholding tax analysis with respect to POC model.

This approach to POC design and implementation allows for the centralization needed to drive efficiencies and process improvement throughout the organization while providing enough flexibility not to affect the performance of the local operations. With appropriate regular maintenance of the structure, this approach leads to a POC with value creating functions and assets to support the operational changes and support the realized tax savings.

Conclusion

In our experience meticulous attention to every aspect of POC operational design is essential to its long-term effectiveness. The systems need to support the new transaction flows. The key performance indicators and incentives should drive behavior supporting the operation model. The systems security and reports should be aligned with the roles and responsibilities of each affiliates' operations. The legal and tax structure must be aligned with the new intercompany transactions flows.

Careful design and consideration must also be given to export documentation, commercial invoices, INCO terms, import documentation, VAT registrations, customs declarations, and more. To manage the tax risks across jurisdictions the behavior, contracts, and record keeping must be consistently executed within the business operating model design.

The BEPS action plan highlights the changing environment of the OECD (and likely renewed focus of local governments) and therefore highlights the importance of careful design and consistent execution of the POC structure. In order to support the changes resulting from the new POC structure, Multinationals must be dedicated to "living the model" across functions and across borders.

Australia: Change of federal government and draft guidance on "exploration"

Change of federal government

The Australian federal government election was held on 7 September 2013 resulting in the Liberal/National Coalition Party (Coalition) defeating the ruling Labor Party (Labor) and forming the new government.

Setting the direction of the nation's fiscal policies will feature prominently as part of the new government's efforts to return the Australian federal budget to surplus.

A number of tax-related measures had been announced by the Coalition during the course of its election campaign. Some of the Coalition's key tax policies and proposed reforms announced to date include:

- Company tax rate to be reduced by 1.5 percent from 30 percent to 28.5 percent with effect from 1 July 2015.
- A paid parental leave levy of 1.5 percent to be introduced for companies with taxable income above A$5 million per annum.
- Carbon tax to be abolished.
- Consultation to be undertaken within two years to produce a comprehensive white paper on tax reform.
- Labor's announced change to the Fringe Benefits Tax treatment of cars will not proceed.
- Mining tax (for coal and iron ore) to be abolished.
- Exploration Development Incentive (EDI) to be introduced from 1 July 2014 for small exploration companies with no taxable income to provide investors with a tax deduction for a proportion of mining exploration expenses.
- Review of the Research and Development (R&D) tax incentive to be conducted, including examination of the potential adoption of the "patent box" model.

In addition, there are as many as 100 unlegislated tax announcements made by the outgoing government (including those announced in the 2013/14 budget handed down in May, as reported in our July edition) and its predecessor governments (some of which date back many years). Unless advised otherwise, the Coalition has reserved its position on these unlegislated announcements, subject to the ongoing state of the federal budget.

It is hoped that the new government will act swiftly to provide Australia with clear, cohesive and robust fiscal policies.

For more information, please refer to the following publication, "2013 Deloitte response to change in Federal Government": http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Services/Tax%20services/Deloitte_response_to_change_in_Federal_Government.pdf

A number of tax-related measures had been announced by the Coalition during the course of its election campaign.

Further guidance on the meaning of exploration for PRRT purposes

On 21 August 2013, the Australian Taxation Office (ATO) published draft taxation ruling TR 2013/D4 which set out its views on the scope of activities that are "involved in or in connection with exploration for petroleum" for Petroleum Resource Rent Tax (PRRT) purposes. A link to the draft ruling TR 2013/D4 is here: http://law.ato.gov.au/atolaw/view.htm?docid=%22DTR%2FTR2013D4%2FNAT%2FATO%2F00001%22

This follows the recent release of the Administrative Appeals Tribunal's decision in *ZZGN v Commissioner of Taxation* [2013] AATA 351 (the ZZGN case) regarding the PRRT meaning of "exploration" (as reported in our July edition).

To understand the significance of classifying expenditure as exploration for PRRT purposes, it is useful to recall that the PRRT is a tax on the upstream profits of petroleum projects whereby each project is ring fenced and PRRT is only paid once the assessable receipts generated by a project exceed all of the costs of the upstream operations. In addition, excess deductions are carried forward and augmented each year. Exploration expenditure is unique in that it may qualify for transferability between petroleum projects (which is an exception to the project ring fencing rule) and it can be augmented at a more favorable rate, compared to other classes of expenditure.

Historically, industry has taken the view that for PRRT purposes, exploration encompasses all the activities in relation to the discovery and determination of a commercially recoverable accumulation of petroleum which support a decision to mine.

Previous draft ATO guidance seemed to support such an interpretation.

The principles now contained in TR 2013/D4 are broadly consistent with the findings of the AAT in the ZZGN case. The key points of TR 2013/D4 are summarized as follows:

- As the term "exploration" is not statutorily defined in the PRRT legislation, it bears its ordinary meaning, not a technical, trade or commercial meaning.

- "Exploration for petroleum" is limited to the "discovery and identification of the existence, extent and nature of petroleum." This includes searching in order to discover the resource, as well as the process of ascertaining the size of the discovery and appraising its physical characteristics (for example, drilling an appraisal well). Once petroleum has been discovered, however, operations and facilities undertaken to evaluate the discovery, such as determining whether it is economically and technically feasible or commercially viable to develop a known petroleum pool or how best to develop it, are not activities involved in or in connection with the exploration for petroleum.

- Feasibility studies (often a grey area in applying these rules) will in most cases not be considered exploration. However, feasibility studies which have a reasonably direct relationship with the exploration for petroleum (as defined above) may be in connection with the exploration for petroleum. For example, feasibility studies that address whether or not to continue exploring.

- Activities which do not fall within the scope of the operations and facilities involved in or in connection with the exploration for petroleum may receive recognition as "general project expenditure" in connection with the project but only once there is a "petroleum project"; that is, when a production license comes into existence.

- Commercial triggers, such as the decision to produce, Final Investment Decision (FID), and phases of activities or similar, do not provide a dividing line between what qualifies as exploration or otherwise for PRRT purposes.

The ATO's current view has the potential to create a significant unintended black-hole for expenditure incurred on activities undertaken to evaluate the economic and commercial viability of developing a petroleum resource for the purpose of making a decision to mine (e.g. Front End Engineering and Design (FEED)), if the development does not ultimately proceed and a petroleum project does not come into existence, as such expenditure will not receive any PRRT recognition.

The ATO intends to apply its views in TR 2013/D4 to payments liable to be made from 21 August 2013. The ATO is seeking comments particularly on the date of effect of the final ruling, and has issued a discussion paper to articulate the matters to be taken into consideration.

For payments incurred prior to 21 August 2013, technically the AAT decision in the ZZGN case (which is largely consistent with the ATO's current views in TR 2013/D4) is the most compelling precedent (as the case was not appealed). However, as noted, this outcome would seem to contradict certain draft guidance previously issued by the ATO. The ATO has now indicated that it would clarify its administrative treatment of payments made before 21 August 2013 at the time the final ruling is issued. It has been suggested that some form of reasonable resolution may be agreed with taxpayers on a case-by-case basis for historical positions adopted by taxpayers.

For affected taxpayers, this leaves an element of uncertainty in relation to past costs (which have been deducted or which are being carried forward). For example:

- There may be increased PRRT liability for projects which have relied upon transferred exploration expenditure from other projects if the expenditure was not in fact exploration in nature and therefore incorrectly transferred. Projects which have carried forward their own exploration expenditure and applied the exploration augmentation rate may also be exposed if the expenditure is reclassified as general project expenditure and augmented at a lower rate.

- Taxpayers will need to reassess any deferred tax benefit which has been recognized in their financial statements in respect of their carried forward exploration expenditures (including any augmentation thereon), whether incurred by the taxpayer itself or inherited from another entity on acquisition, in light of the potential reclassification of such expenditure and the subsequent downward revision to the augmentation rate.

The ATO's current view has the potential to create a significant unintended black-hole for expenditure incurred on activities undertaken to evaluate the economic and commercial viability of developing a petroleum resource for the purpose of making a decision to mine …

- Companies which have had sales or acquisitions of interests in petroleum permits, leases or licenses could be affected in several ways, as the PRRT credits inherited by the buyer may have been affected by changes in the vendor's PRRT profile following any reclassification of expenditure from the exploration to the general project category. These rules can be complex and should be looked at closely, as it may have an ongoing impact on the buyer for many years in the future.

- Taxpayers with interests in onshore permits, leases and licenses which are moving to the PRRT regime from 1 July 2012 could in some circumstances have their opening positions affected as the PRRT rules recognize certain pre-1 July 2012 expenditure and allow them to be deducted post-1 July 2012. These transitional rules similarly distinguish between exploration and non-exploration expenditure.

It is clear that the draft ruling has significant and potentially far-reaching practical implications for PRRT taxpayers and it is critical that taxpayers carefully review the potential impact which it may have for their specific facts and circumstances, and determine the appropriate tax positions to adopt, subject to the date of effect that will ultimately apply.

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Draft ATO taxation ruling – shipping profits

The ATO released a new draft tax ruling on 28 August 2013 in relation to the taxation of shipping income under Australia's domestic freight tax rules (that apply an effective rate of tax of 1.5 percent on the gross shipping revenues derived in Australia) and the interaction with Australia's double tax treaties for nonresident ship owners or operators. A link to the ruling TR 2013/D5 is here: http://law.ato.gov.au/pdf/pbr/tr2013-d005.pdf

Specifically, the ruling compares the interpretation of treaties that adopt the standard OECD shipping profits article as compared to treaties that diverge from the standard.

This ruling will be relevant to those international operators in the oil and gas sector that derive Australian shipping profits, such as nonresident owners or operators involved in LNG cargo transportation and the transport of goods and/or passengers between Australian ports.

The operation of the relatively new Maltese double tax agreement is of particular interest as the tax treaty is seeking to ensure there is no "double non-taxation" of shipping profits by granting taxing rights to Australia for voyages that end out of Australia in certain circumstances (not the standard type of clause that is normally included in treaties). The double non-taxation would otherwise arise where:

- A non-Maltese resident transfers ownership of vessels to Malta and obtains the Maltese exemption for qualifying ships and

- Australian tax would otherwise be avoided if goods are picked up in Australia and the voyage ends outside of Australia.

In our view, this is indicative of the potential future trend treaties may take, as well as the taxation of the sector in general from the ATO's perspective.

For treaties with standard OECD clauses, in relation to nonresidents deriving shipping profits, it is considered that Australia generally retains taxing rights in relation to shipping profits attributable to voyages between Australian domestic ports.

For tax treaties with nonstandard clauses, Australia's right to tax freight income may instead need to be considered under the business profits article, where the shipping profits article does not apply. Some examples include:

- The U.S. convention (whereby the shipping profits article only applies to certain types of leasing income)

- The Italian and Romanian conventions (where "place of effective management" tests must also be satisfied)

- The Philippine and Korean conventions (where the shipping profits article only applies to the operation of ships in international traffic).

Some tax treaties also enable Australia to tax the freight income from voyages that end outside of Australia:

- The relatively recent convention with Malta enables Australia to tax voyages that are discharged outside of Australia unless the Maltese resident company can show that less than 25 percent of its capital is owned directly or indirectly by non-Maltese residents, or the amounts do not fall within the Maltese tax exemption for shipping profits. The purpose of this is to ensure there is no double non-taxation (i.e. no avoidance of Australian tax while also obtaining a shipping exemption in Malta).

- Some conventions grant Australia such taxing rights, but put a cap on the amount of tax recoverable. Examples include the Philippines, Thailand, Kiribati and Sri Lanka.

The ATO also considered the requirement to apportion shipping profits to voyages confined to Australia.
The view in the ruling is not definitive and only refers to a requirement to use a reasonable method of apportionment, which may include having regard to factors such as the time spent loading and unloading goods that are discharged in Australia, the time spent traveling between ports in Australia and the proportion of goods discharged in Australia.

Brazil: Tax updates

IOF changes on external loan transactions

The Financial Transactions Tax (IOF) is imposed on foreign exchange transactions and has been used by the Brazilian government as a tool to stimulate or inhibit the inflow and outflow of foreign currency into or out of Brazil and, consequently, to manage the appreciation or depreciation of the Brazilian Real against foreign currencies.

The Brazilian government published a decree on 5 December 2012 (Decree 7,853) that amends the IOF by again changing the definition of "short-term" for purposes of inbound loans and offshore bond issues (overseas debt). Where such transactions are not "short-term," the IOF rate is 0 percent; where they are short-term (365 days or less), the rate is 6 percent. The measures in Decree 7,853 apply to foreign exchange transactions taking place beginning 5 December 2012.

Brazil amends transfer pricing rules

Financial Transactions

Law 12,766 introduces significant changes to the Brazilian transfer pricing rules on financial transactions, which previously were not well regulated, among other changes.

The new rules represent a significant advance to align the Brazilian transfer pricing rules on these transactions with the international standards by avoiding the adoption of fixed, flat rates. Taxpayers should carefully consider the appropriate limit at the time of the contract date and avoid closing contracts until further clarification regarding the spread (margin) and official source of information for the rates to be used.

The new transfer pricing rules specifically provide that interest associated with intercompany loan transactions should not be deductible if it was not consistent with the six-month LIBOR plus 3 percent annual spread, regardless of registration with BACEN. This change would introduce a flat criterion applicable to all old and new contracts. The basic rule is that the "limit" (maximum for inflows and minimum for outflows) is now a combination of a "rate" plus a "margin" (spread). The Administrative Rule #427/2013 enacted by the Ministry of Finance determined the spread applicable for inflows is 3.5 percent and outflows is 2.5 percent as of 2 August 2013. From 1 January 2013 to 2 August 2013 the spread was 0 percent.

Law 12,715/2012 introduces two additional transfer pricing methods to the existing Brazilian methods: the commodity exchange import price and the commodity exchange export price for inbound and outbound transactions with commodities, respectively.

The new transfer pricing provisions on financial transactions are applicable to new contracts starting on or after 1 January 2013. The new rules grandfather financial transactions entered into before 1 January 2013, as long as they are not renegotiated or amended in tax periods after the new transfer pricing provisions become effective.

New transfer pricing methods for commodities

Law 12,715/2012 introduces two additional transfer pricing methods to the existing Brazilian methods: the commodity exchange import price and the commodity exchange export price for inbound and outbound transactions with commodities, respectively.

The new transfer pricing rules specifically provide that interest associated with intercompany loan transactions should not be deductible if it was not consistent with the six-month LIBOR plus 3 percent annual spread, regardless of registration with BACEN.

Under the additional methods, the basis for comparison is the average commodity exchange price for the relevant items adjusted for upward or downward spreads. The commodity exchange price that should be used corresponds to the average price on the date of the transaction. In cases in which no commodity exchange price exists for the relevant date, the analysis should be based on the average commodity exchange price for the most recent date before the transaction date. For commodity products not negotiated in commodity exchanges, Law 12,715/2012 also allows the use of prices obtained from reputable institutions, to be identified in the tax authorities' regulations.

The new transfer pricing methods must be applied in intercompany transactions involving commodities as from 1 January 2013. In other words, taxpayers are no longer allowed to apply any of the remaining methods to assess the reasonableness of their transfer prices.

ICMS – Interstate operation (imported goods)

The Constitution granted authority to the Brazilian States to tax the circulation of merchandise and rendering of interstate and intermunicipal transportation services and communications (ICMS), even when the transaction and the rendering of services start in another country, including import operations.

The Brazilian Federation adopted ICMS interstate rates for the interstate circulation of goods, aiming to balance the difference among the "poor" and "rich" Federative States operation, at 12 percent or 7 percent, the latter applicable to shipments to states located in Brazil's northern and northeastern regions.

> The Normative Ruling #1.277/2012 published by the Brazilian Revenue Services on 28 June 2012 introduced a new tax collection and reporting obligation (accessory obligation), the so-called Siscoserv …

By passing Resolution 13, dated 25 April 2012 (RSF 13/120), Brazil's Federal Senate reduced the ICMS applicable to imported goods that are sold by a seller located in one state to a buyer in another state to 4 percent. The reduction came into effect on 1 January 2013.

The 4 percent rate applies to imported goods that, after clearing customs, either (i) do not undergo any manufacturing process or (ii) after processing, assembly, packaging, repackaging, renewal, or refurbishment, result in goods that have an "imported content" of more than 40 percent.

ICMS/REPETRO – State of Rio de Janeiro

The ICMS Agreement 130/2007, in force since November 2007, provides the ICMS tax treatment for goods brought to Brazil under the REPETRO, the special customs regime for goods to be used in the research and production of oil and natural gas fields. According to this federative agreement, each of the Brazilian States are authorized to grant (i) an exemption or 1.5 percent (cumulative) rate on importation of goods related to the oil and gas exploration phase and (ii) 3 percent (cumulative) or 7.5 percent (non-cumulative) rate for goods imported under REPETRO during the production phase.

The state of Rio de Janeiro has regulated the convention granting the benefit of exemption of ICMS, through the issue of internal Decree #41.142/2008, for goods brought to Brazil under the REPETRO. Nevertheless, on 14 May 2013, Rio de Janeiro published Resolution #631/2013, changing the exemption in reduction until 31 December 2016. Thus, from May 2013 until December 2016, the applicable rate will be 1.5 percent on importation of goods related to the oil and gas exploration phase.

Siscoserv – New accessory obligation

The Normative Ruling #1.277/2012 published by the Brazilian Revenue Services on 28 June 2012 introduced a new tax collection and reporting obligation (accessory obligation), the so-called Siscoserv, in order to provide information to the government related to transactions between resident or domiciled companies or individuals in Brazil and resident companies or individuals domiciled abroad.

The transactions that must be reported include the import and export of services, intangibles, and other operations that produce changes in equity of individuals, legal entities, or disregarded entities. Note that this report does not include the purchase and sale solely of goods, which already is handled by Siscomex.

The frequency of submission, as a general rule, is on a monthly basis through an online system. The type of the service determines the day from which the company must comply with the new obligation. For example: construction services must comply beginning the month of October 2012; legal and accounting services must comply beginning October 2012; transportation services must comply beginning April 2013; etc.

- A company that fails to submit the report or submits the report with inconsistences is subject to penalties.

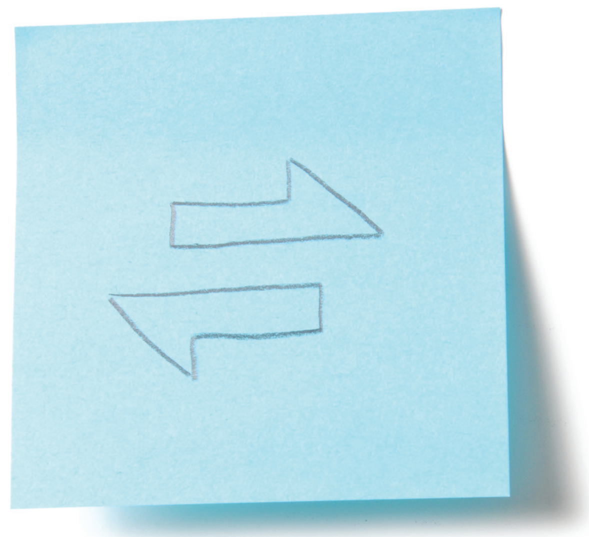
- For non-submission, penalties are as follows: R$500 pe calendar month for corporations under the estimated profit method, R$1,000 per calendar month for corporations under the taxable income method.

- In the case of missing, inaccurate, or incomplete information, penalties are 2 percent, but not less than R$100 over the previous month's gross revenue.

COFINS Importation – Additional 1 percent rate

The COFINS Importation is levied on the importation of goods. The tax basis is comprised of the CIF (value of the goods) and whole tax burden: II (customs duties), IPI (federal tax on industrialized goods), ICMS (tax on the circulation of goods and services), PIS (social integration program), and COFINS (social contribution on revenue) itself (gross-up method). The rate defined by Law #10.865/2004 is 7.6 percent.

Law #12.844/2013 introduced an additional 1 percent rate for specific products imported, listed in the Annex 1 of Law #12.546/2011. According to the Federal Tax Authorities, this change is in force since 1 August 2012, despite the fact that the Law had defined the need for a specific regulation to apply the additional rate. The controversial issue on the effective date will likely generate administrative and judicial litigations.



Consortium: ISS – Municipal tax on services rendered (City of Rio de Janeiro)

The City of Rio de Janeiro published Resolution #2.768/2013 (the Resolution) significantly changing the rules related the service tax (ISS) due by consortiums.

Service providers are subject to a cumulative municipal tax named "Imposto Sobre Serviços" (ISS). Basically, the services taxable are listed in the Annex to ISS National Law 116/2003. The tax basis for the calculation is the service price including the ISS value (gross-up) method.

As a general rule, the operator of the consortium is responsible for issuing invoices, keeping accounting registers, and complying with accessory obligations.
The Resolution, among other changes, provides that the consortium will be responsible for issuing the invoice and collecting the ISS in its own name as well as withhold the tax when applicable. As a result, the consortium needs a Municipal Registration Number.

Another important provision of the Resolution is the fact that the ISS will be due over the management fee charged by the operator of the other parties. The changes have been in force since 18 April 2013.

OECD's BEPS and Canada's anti-treaty shopping initiatives: Implications for investments in the Canadian oil and gas sector

> Nonresidents who own shares of Canadian oil and gas companies through treaty structures should follow these developments in the Canadian international tax landscape very closely …

An important consideration for nonresidents who invest in Canadian oil and gas companies is the Canadian income tax that may be payable on the ultimate disposition of the investment. Under Canadian domestic law, nonresidents of Canada are subject to Canadian income tax on their taxable capital gains realized from the disposition of "taxable Canadian property" (TCP), which includes Canadian resource properties and shares of corporations whose value is derived principally from Canadian resource properties.

Generally, Canada's tax treaties contain exemptions for gains realized by nonresidents on the disposition of shares of Canadian companies, but these exemptions are generally not available for gains realized from the disposition of shares that derive their value principally from Canadian resource properties.

However, certain Canadian treaties, such as the Canada-Luxembourg treaty and the Canada-Netherlands treaty, for example, may exempt these gains as well, provided that certain conditions are met. Accordingly, it has been relatively common for inbound investments in the Canadian oil and gas sector to be structured through one of these jurisdictions.

The OECD's ambitious agenda to address "base erosion and profit shifting" (BEPS) by multinational companies, which is supported by the G8 and the G20, may impact nonresidents who have used these or similar structures to hold their investments in Canadian oil and gas companies. The OECD specifically identified treaty shopping through the use of conduit companies as a potential instance of tax treaty abuse if it results in what is perceived as the inappropriate reduction or elimination of source country taxation, and recommended the adoption of bilateral and/or domestic rules to prevent or deny treaty benefits in those instances. Canada released a consultation paper on 12 August 2013 outlining its view on potential measures that could be used to address perceived treaty shopping into Canada and has invited interested parties to submit comments on possible measures to address treaty shopping. The consultation period will close on 13 December 2013 after which it is expected that the Canadian government will develop its position on this issue. Nonresidents who own shares of Canadian oil and gas companies through treaty structures should follow these developments in the Canadian international tax landscape very closely and nonresidents considering investing in Canadian oil and gas assets should build in sufficient contingencies into their structures to deal with potential changes.

China: New VAT guidance

China's State Administration of Taxation (SAT) has issued guidance (SAT Bulletin [2013] No. 27, (Bulletin 27)) confirming that the 17 percent VAT rate applies to "productive services" carried out by oil and gas enterprises (OGEs) for the exploitation of coalbed gas and shale gas. Bulletin 27 is effective as of 1 July 2013.

The 17 percent VAT rate on productive services in the oil and gas industry was introduced in 2000 by Caishui [2000] No. 32 (Circular 32), which was superseded by Caishui [2009] No. 8 (Circular 8). Productive services for this purpose cover various activities in the crude oil and natural gas production process, such as geological surveying, drilling, extraction, and relevant supporting activities. Circular 8 applies only to enterprises engaged in the production of crude oil and natural gas, although certain OGEs[3] are subject to a 5 percent VAT rate as approved by the State Council. Further, Circular 8 does not apply to productive services provided between OGEs and nonOGEs.

The exploitation of unconventional gas resources – notably coalbed gas and shale gas – are relatively new businesses for Chinese OGEs and, until the issuance of Bulletin 27, it was not clear whether the relevant services fell within the scope of Circular 8. According to the interpretation notes issued with the bulletin, the SAT based its conclusions on the similarities of constituents and properties between coalbed or shale gas and conventional natural gas resources.

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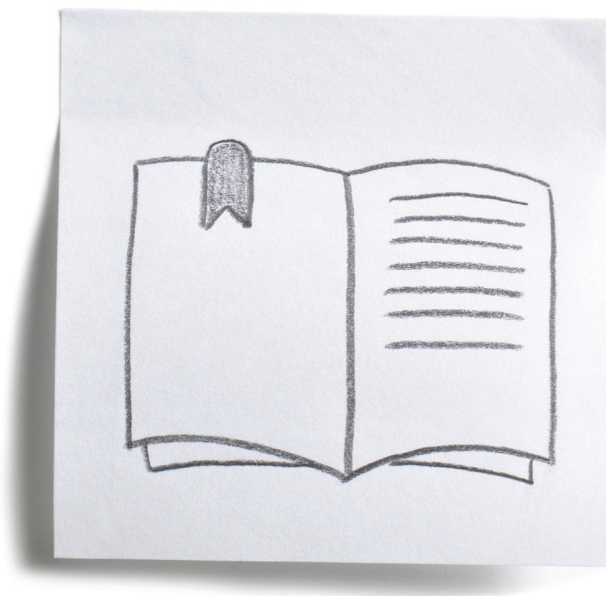

Despite the clarifications provided by Bulletin 27, some issues remain for the coalbed and shale gas businesses, which may require further guidance:

- It is not entirely clear whether the reduced VAT rate (i.e., 13 percent) that applies to the sale of conventional natural gas would be applied to the sale of coalbed or shale gas or whether the 5 percent VAT would be applied to Sino-foreign cooperative joint venture projects engaged in the exploitation of coalbed or shale gas. Bulletin 27 and the interpretation notes imply that the treatment for conventional natural gas should be followed for coalbed and shale gas.

- Some productive services (e.g., geological surveys and transportation relating to the exploitation of gas) may fall within the scope of the VAT reform and should be subject to 6 percent or 11 percent VAT rate under the reform program. Although Bulletin 27 is silent on which tax rate should be used in these cases for the coalbed and shale gas industries, it is generally believed that the VAT reform would override Circular 8.[4]

3 OGEs subject to the 5 percent VAT levy rate are Sino-foreign cooperative joint venture projects engaged in the exploitation of oil and gas and the China National Offshore Oil Corp and its affiliates. Input VAT is not recoverable when the 5 percent VAT is collected.

4 See Notice on Tax Policies for the Nationwide Pilot Program for the Conversion of Business Tax to VAT in the Transportation and Certain Modern Service Industries (Caishui [2013] No. 37).

East Africa: Tax updates

All services provided by nonregistered, nonresident companies to a resident company or PE of a nonresident are to be subject to withholding tax at 20 percent.

Kenya

Readers will recall that at the beginning of 2013 Kenya introduced a withholding tax on transfers of shares and other rights related to oil and mining companies or projects. This imposed a 10 percent withholding in relation to payments to residents and permanent establishments (PEs) and a 20 percent withholding in the case of a payment to a nonregistered, nonresident entity. The 2013 Finance Bill proposes to make this withholding tax creditable against the payee's final Kenyan income tax liability in the case of residents and PEs rather than a final tax as originally introduced. The proposed effective date is 1 January 2014 but the Kenyan National Assembly has not yet approved the change.

This is a positive development but still leaves many issues unanswered. For example, exploration projects are not likely to have any income tax liability in the case of a farm-down, as reimbursements are sheltered by past costs and the value of a work program is not treated as taxable consideration under the Income Tax Act. Does this mean that the tax authorities will repay the withholding tax? One hopes so, but the Kenya Revenue Authority's record of making tax repayments is not good.

We will update readers on future developments.

Mozambique

A new draft of the law establishing the taxation regime for petroleum operations has been released and is expected to come into force in January 2014. This has not yet been approved by the Council of Minister and Parliament, so this date may still change. The main proposals are as follows:

- Abortive exploration expenses will not be tax deductible.

- There will be restrictions on the ability to offset costs of downstream and midstream activities against income from upstream operations. The basis for offset will need to be agreed on a case by case basis with the relevant ministry and the tax authorities.

- Signature bonuses will be tax deductible but production tax (which is effectively a royalty) will not be tax deductible.

- Costs resulting from the negligence or fault of the taxpayer or any person acting on its behalf will not be tax deductible.

- All services provided by nonregistered, nonresident companies to a resident company or PE of a nonresident are to be subject to withholding tax at 20 percent. The withholding tax increases to 25 percent when the payments are related to commissions, subsidies, bonuses, or other similar remuneration to associated companies, managers, or administrators.

- Interest and other financing expenses will not be cost recoverable. For income tax purposes, the thin capitalization rules (which impose a maximum debt to equity ratio of 2 to 1) will apply in the case of loans from both related and unrelated parties.

- The current VAT exemption applicable to the acquisition of services related to prospecting, exploration, and construction of infrastructure will not be available after January 2015.

- Capital gains arising to nonresidents with or without a PE from the direct or indirect disposal of petroleum rights in Mozambique will be taxed at a 32 percent rate. Petroleum rights are to be explicitly defined as immovable property in order to reduce the possibility of a disposing party successfully seeking treaty relief from tax. No taper relief will be available from January 2014. The acquirer is to be jointly and severally liable for any tax arising.

The proposals will not apply to existing exploration and production concession contracts.

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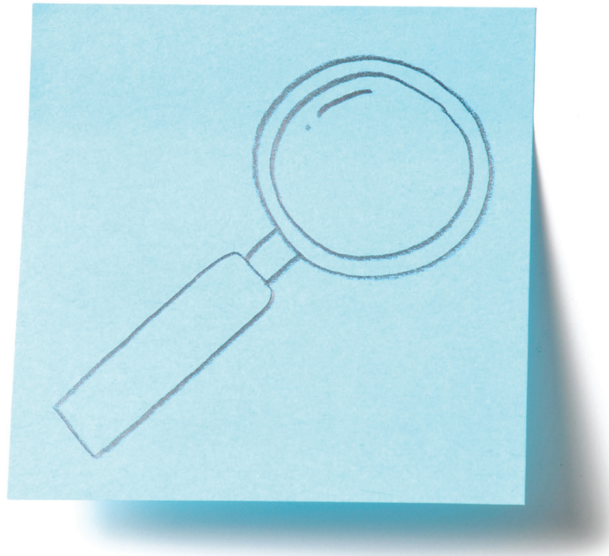


Tanzania

The 2013 Finance Act came into effect on 1 July 2013 and introduced four changes which could significantly impact the developing upstream industry in the country.

Ring fencing

The ring fencing for mining activities introduced in 2010 has now been applied to upstream activities. Taxpayers are no longer permitted to offset deductions arising from one "petroleum contract area" against profits arising from another. It is not clear how this will apply to deductions arising prior to 1 July 2013 or whether there would be any protection from the adverse impact under the economic stabilization article of existing Production Service Agreements (PSAs).

Withholding tax on services

In an effort to improve tax compliance and collections, Tanzania has introduced a 5 percent withholding tax (WHT) on payments for services between registered taxpayers. The WHT will be creditable against the final income tax liability of the taxpayer for the relevant period but taxpayers with losses or insufficient income to fully use the credits will be dependent on the revenue authorities to make repayments, which will be, at least, time intensive. The WHT will apply to most forms of service, including construction services (e.g., engineering, procurement, and construction management, or EPCM contracts), and is likely to make gas field development more expensive as service providers pass the cash flow cost on to customers.

> … Tanzania has introduced a 5 percent withholding tax (WHT) on payments for services between registered taxpayers.

Alternative minimum tax

The Income Tax Act now provides that a taxpayer in a loss position for five consecutive years should, in year five, (and consecutive periods where there are losses carried forward) pay income tax equal to 0.3 percent of turnover. This will impact field developments and other infrastructure projects where heavy capital investment is likely to result in loss carry forwards for lengthy periods after production commences.

Tax depreciation

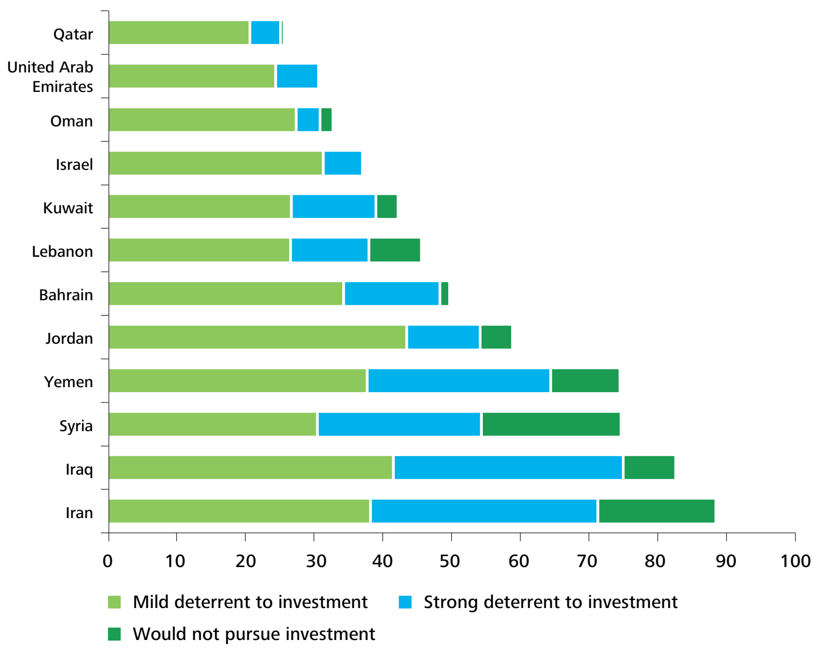
Capital expenditures on equipment used in prospecting and exploration for minerals or petroleum has been added to the list of items eligible for 100 percent immediate relief under Class 8 of the Third Schedule to the Income Tax Act. This would primarily impact oilfield services and drilling companies, though in fact most of these are likely to use leased equipment.

Uganda

The Petroleum (Exploration, Development, and Production) Act, 2013 contains a clause that implies that goods and services for the petroleum sector should be provided through companies with at least 48 percent Ugandan ownership. It is not yet clear what constitutes Ugandan ownership for these purposes (for example, it may exclude ownership by another Ugandan company which has more than 49 percent foreign ownership). Coupled with the recent attempt to encourage localization of service provision by preventing the crediting of reverse charge VAT, this is likely to place significant commercial, legal, and tax burdens on the still fragile Ugandan oil industry.

Lebanon: Fueling interest in offshore oil and gas exploration

Since Lebanon passed The Offshore Petroleum Law No. 132 of 2010, interest surrounding Lebanon's emerging oil and gas sector has been increasing. In 2012, a public policy research organization, Fraser Institute, ranked Lebanon seventh in the Middle East and North Africa (MENA) region in terms of attractiveness for upstream oil and gas investment. Interest has subsequently been boosted by the formation of Lebanon's Petroleum Administration in December 2012 and by a report published in February 2013 by French consultancy firm, Beicip Franlab, which estimated Lebanese offshore oil reserves at between 440 million and 675 million barrels.



Source: Figure 20: All-Inclusive Composite Index – Middle East, Fraser Institute Global Petroleum Survey, 2012.

… Lebanese officials are considering introducing a more practical, single type of tax at a rate of 25-30 percent to replace the existing corporate income tax rate of 20 percent and branch remittance tax of 10 percent.

In April 2013, Lebanon's Minister of Energy and Water, Gebran Bassil, announced the 46 international and local oil and gas companies who had successfully pre-qualified to apply for offshore hydrocarbon exploration contracts in Lebanon. The 12 pre-qualified Right-Holder Operators and 34 Right-Holder Non-operators invited to participate in Lebanon's First Offshore Licensing Round will now bid for five blocks, with a further five potentially being made available.

Despite the delay in the issuance of two decrees necessary to start the bidding process, which caused the deadline to submit bids to be pushed back from the 4 November 2013 to 10 December 2013, there remains significant interest from major international oil and gas companies.

With plans to sign contracts in early 2014, ready for production to commence in 2016, officials are currently in the process of finalizing new tax legislation for the oil and gas industry. While some petroleum related legislation has been passed, specific fiscal provisions that apply to the upstream oil and gas activities have not been finalized.

Under current domestic tax laws, businesses are subject to corporate income tax on income generated from activities "in or through" Lebanon, at a rate of 15 percent. Dividend payments and branch remittances are then subject to withholding tax at a 10 percent rate. It is widely anticipated that the new Petroleum tax law will increase the rate of corporate income tax applicable to upstream activities, possibly to a rate of 20 percent, yielding a total tax leakage on profit repatriations of 28 percent. However, for practical purposes, we understand that Lebanese officials are considering introducing a more practical, single type of tax at a rate of 25-30 percent to replace the existing corporate income tax rate of 20 percent and branch remittance tax of 10 percent.

In addition, it is not expected that either the final Exploration and Production Agreements (EPAs) or the new oil and gas tax law will provide any significant exemptions from other domestic taxes in Lebanon, with the potential exception of stamp duty on the EPA contract itself. Therefore, businesses in the upstream sector may be subject to VAT and employment taxes of around 20 percent.

Lebanon's wealth of offshore oil and gas reserves promise to provide not only exciting new investment opportunities for investors, but potential for Lebanon to remedy its electricity shortages and give a much needed boost to its economy.

Talk to us

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