

## Global oil & gas tax newsletter

### Views from around the world

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# Spotlight on the United States: Under the radar? The challenges of managing U.S. rotational cross-border employees

Many oil & gas companies rely heavily on rotational<sup>1</sup> employees to staff critical projects and alleviate local talent shortages around the world. Deloitte survey data indicates that rotator assignments continue to grow in popularity. While most companies have comprehensive policies and procedures in place for traditional long-term expatriate assignments, many companies have not yet made an adequate effort to confirm that their rotators are fully compliant. As tax authorities around the world become more sophisticated and more aggressive at enforcing the rules, companies face heightened exposure not only to taxes and penalties, but also reputational damage for failure to comply.

This article starts by examining individual income tax considerations for rotators outbound from the United States, then discusses company policy considerations.

Given the broad reach of this topic, the goal of this article is not to capture every potential issue,<sup>2</sup> but rather to raise awareness of the exposure that rotators can create.

## **U.S. outbound rotators**

U.S. tax law contains fairly well-defined rules for short-term business travelers and traditional long-term expatriates. U.S. outbound rotators, however, do not fall neatly into either category and thus pose a challenge from a U.S. tax perspective. Two key tax issues for U.S. outbound rotators are whether they can claim the Internal Revenue Code (“I.R.C.”) §911 exclusions and whether their company-paid travel expenses should be considered a taxable benefit.

- <sup>1</sup> For purposes of this article, rotational employees (or “rotators” for short) are U.S.-based employees who regularly work in another country, typically on a fixed schedule such as 28 days on/28 days off.
- <sup>2</sup> For example, this article does not go into detail on important cross-border matters such as permanent establishment, social security, payroll, immigration, or host country tax implications.

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### The I.R.C. §911 exclusions – do rotators qualify?

The typical long-term expat who moves from the U.S. to a foreign country for an assignment of more than one year will generally be able to benefit from the I.R.C. §911 foreign earned income and housing exclusions, but what about a rotator? The foreign earned income exclusion allows a qualifying individual to exclude up to \$97,600 of foreign earned income from gross income (calendar year 2013 amount).<sup>3</sup> Similarly, the foreign housing exclusion allows for an exclusion from gross income for a portion of the employee's housing expenses incurred in the foreign country.<sup>4</sup>

To qualify for the §911 exclusions, a taxpayer must first be deemed to have his or her "tax home" in a foreign country.<sup>5</sup> For the typical long-term expat who lives and works in a foreign country, this "tax home" threshold is easy to satisfy. However, for a U.S. rotator, I.R.C. §911(d)(3) provides an obstacle by specifically denying the existence of a foreign tax home for any taxpayer maintaining their "abode" within the United States.<sup>6</sup>

"Abode" is not specifically defined in the regulations,<sup>7</sup> but case law refers to it as "one's home, habitation, residence, domicile or place of dwelling."<sup>8</sup> For example, in *Musshafen v. Comm'r*, the taxpayer worked a 35-days-on, 35-days-off rotational assignment in Kuwait.<sup>9</sup> When not working, the taxpayer would return to his home in Oklahoma where his wife and daughter resided.<sup>10</sup> The court held that as all of the taxpayer's economic, family, and personal ties remained in Oklahoma, so did his abode, which precluded him from having a tax home in a foreign country and thereby prevented him from qualifying for the §911 exclusions.<sup>11</sup> In addition to the place where a taxpayer maintains a home for his family, other relevant factors pointing to an abode in the United States include maintaining U.S. bank accounts, a U.S. driver's license, and U.S. voter registration.<sup>12</sup> Based on these rules, the typical U.S. rotator who maintains a home in the U.S. and "works under rigorous conditions in isolation away from his family and friends and generally only in the company of his co-workers"<sup>13</sup> would not qualify for I.R.C. §911 exclusions.

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For the reasons discussed above, it would prove difficult for a typical U.S. outbound rotator to successfully claim the I.R.C. §911 exclusions if he or she maintains an abode in the U.S.

If your company's rotators are "on their own" to prepare their U.S. tax return, they may mistakenly claim the §911 exclusions thinking that they qualify. While an employer is not responsible for positions claimed on an employee's individual tax return, and should not provide tax advice, it is important to note that:

- Rotators who claim the §911 exclusions in error would be subject to back taxes, plus potential penalties and interest on the balance, if the position is rejected by the IRS.
- Rotators who claim the §911 exclusions in error may be less willing to end their rotations, as doing so would result in a tax increase once they permanently return home and no longer claim §911.
- Rotators may submit a Form 673 to payroll in order to request a reduction in their U.S. income tax withholding. Form 673 may only be used by employees who expect to qualify for the §911 exclusions. The purpose of the form is to advise payroll to reduce U.S. income tax withholding to account for the income that can be excluded from tax under §911. Thus, in most cases, the company should not rely on a Form 673 submitted by a rotator.

- 3 I.R.C. §911; Rev. Proc. 2012-41.17.
- 4 I.R.C. §911(c).
- 5 I.R.C. §911(d)(1). Under I.R.C. §911(d)(3), the term "tax home" means the individual's home for purposes of I.R.C. §162(a)(2), relating to traveling expenses while away-from-home. Note that the term "tax home" has nothing to do with whether the individual is subject to tax in the host country. §162(a)(2) is discussed later in this article.
- 6 I.R.C. §911(d)(3).
- 7 See Treas. Reg. §1.911-2(b).
- 8 *Bujol v. Comm'r*, 53 T.C.M. (CCH) 762, 763 (1987).
- 9 *Musshafen v. Comm'r*, T.C. Summary Opinion 2009-115 (July 23, 2009).
- 10 *Id.*
- 11 *Id.*
- 12 I.R.S. Adv. Mem. 2009-003 (Apr. 10, 2009).
- 13 *Miller v. Comm'r*, 55 T.C.M. (CCH) 1717 (Aug. 25, 1988).

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## Defining taxable compensation for rotators is a challenging task and an area of exposure for many companies.

### Company-paid travel expenses – taxable compensation for rotators?

Most companies do a good job capturing taxable compensation in Forms W-2 for long-term expats. But many have not considered whether certain rotator expenses, such as host country housing, airfare, and per diems, are compensatory items that need to be captured in the W-2s as taxable wages. Defining taxable compensation for rotators is a challenging task and an area of exposure for many companies.

I.R.C. §162(a)(2) allows a deduction for ordinary and necessary business expenses paid or incurred while an employee is temporarily “away-from-home.” This means that a company can reimburse business expenses for an employee who is temporarily “away-from-home” and the reimbursement is **not** considered taxable compensation.<sup>14</sup> Likewise, a company can pay a per diem to cover housing or meals (in lieu of reimbursing actual expenses) for an employee who is temporarily “away from home” and the per diem is not considered taxable compensation as long as the per diem is equal to or less than the government-specified per diem rate.<sup>15</sup> If the company pays a per diem that exceeds the government-specified per diem rate for an employee who is temporarily “away from home”, then only the excess is considered a taxable benefit.

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## At first glance, rotator travel expenses ... may appear to be non-taxable compensation, but this may not be the case ...

At first glance, rotator travel expenses (such as housing, airfare, and per diems) may appear to be non-taxable compensation under §162(a)(2), but this may not be the case, as explained below. Note that if an employee does not meet the requirements of §162(a)(2), then certain company-paid expenses should be considered taxable compensation and thus included as wages in the Form W-2.<sup>16</sup>

First, a determination should be made regarding whether the rotator’s assignment is “temporary”, as only individuals who are temporarily away from home are eligible for §162(a)(2). Employment in a single location which is expected to and does last one year or less will be considered “temporary.”<sup>17</sup> An assignment expected to last more than one year (or expected to last for an indefinite period of time) will not be considered temporary.<sup>18</sup>

A related consideration is the location of a taxpayer’s “home.” The taxpayer’s “home” is generally considered to be “the individual’s regular or principal place of business.”<sup>19</sup> The application of these concepts may be best explained through a few examples.

### Example 1

A U.S. employee has been working for XYZ Company in the U.S. for the past five years, occasionally rotating to other countries to assist with projects. During 2012 he went on four 28 day rotations to Equatorial Guinea (“EG”). He has no plans to return to EG during 2013.

Given this fact pattern:

- The U.S. would remain the employee’s “home” since the U.S. is his regular place of business.
- The employee’s trips to EG would be considered “temporary” because they were expected to last (and did last) less than one year.
- Accordingly, the employee meets the requirements of §162(a)(2) and the company can treat his rotator travel expenses as non-taxable.

<sup>14</sup> Treas. Reg. §1.62-2.

<sup>15</sup> U.S. General Services Administration, see [www.gsa.gov](http://www.gsa.gov), or for non-U.S. per diem rates, see Department of Defense website at [www.defensetravel.dod.mil/site/perdiemCalc.cfm](http://www.defensetravel.dod.mil/site/perdiemCalc.cfm).

<sup>16</sup> With regard to per diems, note that the entire per diem (not just the excess over the government-specified per diem rate) will be considered taxable compensation when an employee does not meet the requirements of §162(a)(2).

<sup>17</sup> Rev. Rul. 93-86, 1993-40 I.R.B. 4.

<sup>18</sup> *Id.*

<sup>19</sup> Rev. Rul. 73-529, 1973-2 C.B. 37.

### Example 2

Continuing from the prior example, except this time the U.S. employee is going to work on a two-year project in Brazil. He expects to rotate 28-days-on / 28-days-off for the duration of the two-year project. Given that his employment in Brazil is expected to last for more than one year, his assignment would not be considered “temporary” and therefore does not qualify for I.R.C. §162(a)(2). In this scenario, the company has an obligation to capture certain travel expenses as taxable compensation.



### Example 3

Big Oil Company is staffing up for a multi-year project in Canada. Mr. Brown, who lives in New York with his wife and three kids, is an ideal candidate. Big Oil wants to hire Mr. Brown, but the wife and kids will not move, so Big Oil is able to sign him by agreeing to cover his weekly airfare to and from Canada, along with an apartment in Canada. In this situation, Mr. Brown’s “home” is in Canada for §162(a)(2) purposes, as his regular place of business is in Canada. Accordingly, both the airfare and rent paid by the company should be considered taxable compensation.

As discussed above, the value of housing provided to an employee in the work location should not be considered a taxable benefit when the employee is temporarily “away-from-home.” On the other hand, if the employee is not considered temporarily “away from home”,<sup>20</sup> then the full value of the housing should be included in taxable compensation.

I.R.C. §119(a)(2) provides another possible way to treat rotator housing as non-compensatory. If the employee is required to live on the business premises for the convenience of the employer, the value of the housing may be excluded from the employee’s gross income.<sup>21</sup> This is sometimes referred to as the “camp housing” exclusion. As rotators sometimes have to live on an oil rig or in a company compound, where public housing is unavailable, this exception may apply.

In summary, a company **should** include certain rotator travel expenses in taxable compensation when:

1. The rotator’s employment in a single location is expected to last more than one year, or,
2. The rotator’s “tax home” (*i.e.*, regular or principal place of business) is in the work location.

Common benefits provided to rotators might include:

- company-provided housing in the work location;
- airfare between the U.S. and the foreign work location; and
- a per diem to cover meal & incidental expenses.

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If the employee is required to live on the business premises for the convenience of the employer, the value of the housing may be excluded from the employee’s gross income.

<sup>20</sup> However, if the value of the housing exceeds the government-specified per diem amount, then the excess is considered taxable compensation.

<sup>21</sup> I.R.C. §119(a)(2).

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## Employer concerns include: host country payroll requirements; permanent establishment; intercompany payments; and the availability of treaties to avoid or minimize host taxes.

Companies spend significant sums on rotator airfare, given their frequent trips to and from the project site. Rotator airfare is considered non-taxable if the employee is temporarily “away-from-home,” as previously discussed. We saw above that rotator airfare is considered a taxable benefit if the rotator is planning to work for more than a year in the work location.<sup>22</sup>

The treatment of per diems intended to cover meal and incidental expenses can be summarized as follows:

- If the employee is temporarily “away from home” as defined by §162(a)(2), and the amount of the per diem is equal to or less than the government-specified per diem rate (which varies by city<sup>23</sup>), then the per diem would not be considered a taxable benefit.<sup>24</sup> If the per diem exceeds the government-specified rate, then the excess is considered taxable.
- If the employee is **not** temporarily “away-from-home” as defined by §162(a)(2), then the entire amount of the per diem is considered a taxable benefit.

Two final points regarding taxable compensation for tax equalized or tax protected rotators:

- (1) When a rotator is subject to tax in the foreign country, and if the company pays the foreign tax on the rotator’s behalf, the employer must include the foreign tax paid by the company as taxable compensation in the rotator’s Form W-2. This is true regardless of the length of the rotation or whether the rotator is considered to have his tax home in the foreign country.

- (2) For any of the above benefits deemed taxable, the company may need to gross up these payments for income and social taxes. This gross up will further increase the company’s costs.

### Host country tax considerations

While thus far we have only considered the U.S. tax implications of cross-border rotators, the implications in the host country should also be considered both as they relate to employees and employers. Employees may only be concerned with any foreign tax liabilities including income tax, social tax, and other forms of tax in certain locations. Employer concerns include: host country payroll requirements; permanent establishment; intercompany payments; and the availability of treaties to avoid or minimize host taxes.

In addition to the fact that rotators may be subject to income tax in the host country, employers may also be liable for reporting compensation and remitting taxes in the host jurisdiction. These taxes may include not only employees’ required income tax remittances but also employer social and payroll taxes and potentially mandatory contributions to employee pension, insurance, and benefit plans.

Employers should be aware that sending employees to work in foreign jurisdictions can create a “permanent establishment” for the U.S. company in that host location. A permanent establishment means that the U.S. employer would have a taxable presence in the host location. Many employers wish to avoid this taxable presence, and in many circumstances, there is planning available to minimize the risk of corporate tax implications in the host location due to the employee’s presence there.

### Treaties

An income tax treaty between the U.S. and the host country may allow a rotator to avoid host country income tax under the “dependent personal services” or “income from employment” article<sup>25</sup> if the rotator spends a limited amount of time in the foreign country during the year. However, this exemption is frequently conditioned on the employer not charging the employee’s costs to the host country, which may not be a viable or practical business solution.

<sup>22</sup> Treas. Reg. §1.162-2(e); See also, *Comm’r v. Flowers*, 326 U.S. 465 (1946); See also, *Jordan v. Comm’r*, 490 F.3d 677 (8th Cir. 2007).

<sup>23</sup> U.S. General Services Administration, see [www.gsa.gov](http://www.gsa.gov), or for non-U.S. per diem rates, see Department of Defense website at [www.defensetravel.dod.mil/site/perdiemCalc.cfm](http://www.defensetravel.dod.mil/site/perdiemCalc.cfm).

<sup>24</sup> Rev. Proc. 2011-47, 2011-42 I.R.B. 520.

<sup>25</sup> Note that “dependent personal services” and “income from employment” are not two different treaty articles in the same treaty. Rather, they are the names used to identify a similar provision found in many treaties.

A rotator might also benefit from a social security treaty (commonly referred to as a Totalization Agreement) which may allow him or her to remain in the home country Social Security system (and therefore be exempt from host country social taxes) while working in the host location. Careful analysis of the totalization agreement would be needed to determine the availability of the exemption from host country social taxes. If eligible, an application needs to be submitted to the U.S. Social Security Administration in order to request a "Certificate of Coverage," which serves as proof that the individual has met the requirements.

### Policy considerations

If employers want to fully comply with the tax regulations in the U.S. and host countries for their rotators, decisions will need to be made regarding the policies and procedures needed to ensure both rotator and company compliance. Among the policy decisions employers need to consider include:

- What internal stakeholders need a say in the decisions to be made?
- What are our competitors doing and what impact would changes have on our ability to retain our rotators?
- What allowances/benefits should we provide to be competitive?
- What are the costs and benefits of each policy provision?
- How can we determine that the policy supports our overall talent strategies?

Given the unique aspects of rotators, companies often conclude that a new policy is necessary. A companies' existing policy for long term expats can be a good starting point in the discussion for the design of a new rotator policy. If a new policy is warranted, an effective communication strategy will be key to the successful rollout and implementation of the policy.

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From purely a tax perspective, employers should consider:

- Whether to provide U.S. and host country tax preparation assistance. There is a cost to engaging a third-party tax provider, but with it should come the peace of mind that taxes in the U.S. and host country are being handled correctly.
- Whether to tax equalize, tax protect, or leave rotators responsible for their own taxes. Tax equalization would hold the rotator responsible for the same level of tax that would have been incurred in their home location. Tax protection means that they pay no more than would have been incurred in their home location, but allows the individual to keep the benefit of a lower total tax. Without these measures, the potential risk and reward stay with the rotator, and could give them an incentive to bend the rules.

In our experience, the tax policy is a very important piece of the puzzle. For example, it is not uncommon for two rotators from different countries working side-by-side on the same project to have vastly different net pay. Further, the financial impact of the tax policy, both from an employee and employer perspective, is often not well understood. So when the policy provides a financial benefit to the rotators, companies often miss the opportunity to communicate this value to the rotator.

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### Conclusion

Rotators are a critical resource for many oil and gas companies. They pose a difficult challenge, both from a tax and company policy perspective. As we start a new year, this may be an ideal time to move your organization toward a more compliant and sophisticated approach for addressing your rotational employees and their tax issues.

### Participation in the Deloitte benchmarking survey

Deloitte is currently updating our benchmarking survey of rotator policies and procedures in the oil & gas industry. If your organization would like to participate and receive a copy of the results, please contact Chloe Yates at [cyates@deloitte.com](mailto:cyates@deloitte.com).





# Indonesia: Court declares BP Migas unconstitutional

In late March 2012, several local non-governmental organizations (“NGOs”) and individuals filed a judicial review to the Indonesian Constitutional Court against several provisions of its oil & gas Law No. 22/2001, specifically those related to the authority and role of BP Migas, the Indonesian upstream oil and gas regulator. In November 2012, the Court issued its decision in favor of the applicants, declaring BP Migas unconstitutional. Accordingly, BP Migas is no longer the official representative of the Indonesian Government effective since the announcement, 13 November 2012.

In order to ensure a smooth transition, the Government has swiftly responded to the Court’s decision and issued Presidential Decree No. 95/2012, which accomplishes the following: assigns all duties, roles and functions of BP Migas to the Ministry of Energy and Mineral Resources (“MEMR”); confirms the effectiveness of existing Production Sharing Contracts (“PSCs”); and makes it clear that all management and supervisory roles previously performed by BP Migas in relation to upstream oil & gas activities in Indonesia will be resumed by the MEMR. The MEMR further assigned all duties, roles and functions relating to upstream activities to a temporary task force, SKS Migas, within the MEMR, which all employees of BP Migas were reassigned to. In early January, the Government then issued a Presidential Decree to establish a special task force, SKK Migas, and also introduced a committee to supervise the special task force’s operation. The committee supervising SKK Migas is comprised of the deputy of the MEMR, the deputy Minister of Finance and the head of the Investment Coordination Board.

Despite the quick response from the Government, potential delays are anticipated in ongoing upstream activities (*e.g.*, approvals, annual budget, procurement, etc.) because the majority of the upstream operating procedures and policies were previously regulated and supervised by BP Migas. Taxpayers should also be alert to further developments in connection with amendments to the Oil and Gas Law that may be made to implement the above changes.



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# Kenya: New tax charge on disposals of mining and oil assets



## Background

The past 18 months have seen considerable excitement about the hydrocarbon potential of East Africa in general, and Kenya in particular, with a number of high profile acquisitions and dispositions involving Kenyan Production Sharing Agreement (“PSA”) interests. Concerned that the country is missing out on tax revenues from these transactions, the Kenyan Parliament has approved new legislation which will impose a new tax charge on transactions involving oil and mining assets. As far as we are aware, these amendments were approved in Parliament in December 2012, but are still pending presidential approval. They may take effect from 1 January 2013, though this is not completely clear as the revised bill has not been issued. What is clear is that the Government is determined to tax such transactions and is attempting to tax one that took place during 2012, notwithstanding that the new law was not in force.

## What transactions are affected?

Tax on capital gains is currently suspended in Kenya, and while sales of direct interests in PSAs are already taxed as income under the Ninth Schedule to the Income Tax Act, there is nothing which taxes indirect disposals (*e.g.*, of shares in companies holding PSA interests). The proposals will introduce a tax charge on “the sale of property or shares in respect of oil companies, mining companies or mineral prospecting companies.” The amendments define sales of property or shares as including “the assignment of rights, sale of companies and businesses, and takeovers or any other non-inventory assets.”

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The amendments will deem sales consideration in respect of affected transactions to be Kenyan source income, and will require the payer to apply withholding tax.

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This change is likely to act as a major inhibitor to the M&A process.

## How does the new charge work?

The amendments will deem sales consideration in respect of affected transactions to be Kenyan source income, and will require the payer to apply withholding tax. In the case of a sale to a resident or to a Permanent Establishment (“PE”) of a non-resident, the withholding tax rate will be 10%. In the case of a sale to a non-resident without a PE, the withholding tax rate will be 20%. The tax rate will be applied to the total proceeds (including non-cash elements), with no deduction for costs.

## Our view

The amendments do not appear to have been carefully thought through and create significant uncertainty, which will be a major inhibitor of future merger and acquisition (“M&A”) activity in the affected sectors in Kenya. Firstly, the reference to oil companies is strange although this could be a drafting error in the original proposal, which may have been addressed when the final Bill was tabled in Parliament. Is the intention to exclude companies exploring for or producing gas? Furthermore, an oil company could also include a downstream business engaged in refining or retail. Secondly, the interaction with the existing charge on disposals of PSAs under the Ninth Schedule is unclear. Does this mean that there will be a double tax charge? Thirdly, it is not clear how the withholding mechanism would apply (if at all) in the case of a transfer of shares between two non-residents, neither having a PE in Kenya. Fourthly, it is not clear how (if at all) the charge will interact with the tax regime under PSAs which generally provide for protection from adverse tax changes and allocates income tax out of the government’s share of production.

M&A in the upstream industry is about the efficient allocation of risk and capital. This change is likely to act as a major inhibitor to the M&A process. The law of unintended consequences is likely to apply, as less M&A will slow down exploration and development activity, reducing tax revenues, and at the same time there will be few transactions generating little incremental tax from M&A to make up the shortfall.

# Mozambique: Clarification on taxation of gains and increased burden on M&A

Mozambique has introduced changes to its tax rules effective from 1 January 2013. Following a number of high profile transactions in the natural resource sector recently, the new rules will clarify the basis of taxing such transactions and increase the potential tax liability significantly:

1. Transactions between non-residents will be explicitly taxable where they relate to assets located in Mozambique, even if the buyer and seller have no presence in Mozambique. Taxable transactions will include sales of shares and other interests or rights.
2. The tax rate applicable to such transactions will be the regular rate of 32%. Previously a “taper relief” had been available to reduce the tax charge in the case of assets held for periods longer than 12 months.

We understand that non-residents with no presence in the country will be required to register in Mozambique in order to pay the related taxes.

The Government has already taken the position that transactions in shares deriving value from Mozambique assets give rise to a tax liability in Mozambique, as in the recent Cove Energy transaction. This legislation makes the basis for such a charge much clearer. The withdrawal of taper relief will increase the potential tax liability significantly. The reduction in the tax charge was up to 70% in the case of assets held for more than 5 years. The legislation does not, however, explicitly address how tax will be collected in the case of transactions in the shares of publicly traded companies and we question the practicality of taxing normal stock market trading transactions.

This development mirrors similar initiatives by the Kenyan and Tanzanian governments to strengthen their rights to tax such transactions.

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# Poland: Recent developments in hydrocarbon taxation

According to the proposed regulations, producers will pay, apart from the current 19% corporate income tax, both a new production-based royalty and a special hydrocarbon tax.

The Polish government released in October 2012 the proposed outline of the new taxation and regulatory changes in the hydrocarbon sector, which will impact both conventional and unconventional oil and gas production in Poland. The exact wording of the bill (key for practical consequences of the changes) is still unknown – it is scheduled for publication in the first quarter of 2013.

According to the proposed regulations, producers will pay, apart from the current 19% corporate income tax, both a new production-based royalty and a special hydrocarbon tax. The royalty tax will be levied on the extraction of natural gas and crude oil at a rate of 5% and 10%, respectively. The hydrocarbon tax, in turn, will apply at a rate of 25% to the difference between revenues and costs from hydrocarbon production (as a type of a cash flow tax). In addition, the current extraction fees will increase, on average, four times. Some additional changes may also be introduced to the current corporate income tax provisions, *e.g.* with respect to depreciation of mining equipment.

The regulation proposal also assumes the creation of a state-owned operator, National Energy Minerals Operator (“NOKE”). The new entity will primarily take on a supervisory role over the oil and gas industry, holding a share in exploration projects (although details are not available yet). Profits generated by NOKE will be distributed to the central budget, municipal government budgets, as well as to a planned Hydrocarbon Generations Fund, which is aimed at contributing towards long-term investments.

The proposed regulations are also intended to establish a system of license tenders, with a mechanism of prequalification of the entities seeking to acquire new exploration licenses. Under the new regulations, the resale of hydrocarbon licenses will only be permitted to buyers preapproved by the government. However, current holders of exploration licenses will keep the preemptive right to acquire production licenses related to their acreage. In addition, non-drilling exploration work will be allowed without a license.

The new tax and regulatory framework is expected to be introduced in Poland in 2015. It is intended to find a balance between the state’s interest and the revenues of the oil and gas industry. In order to attract continued investment in Poland, the hydrocarbon bill (still to be published) should properly address the nature of unconventional projects. Before the official publication of the bill, a comprehensive assessment of the proposed regulations would be premature.

The regulation proposal also assumes the creation of a state-owned operator, National Energy Minerals Operator (“NOKE”).



# South Africa: Nascent oil & gas tax rules

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## Increased level of activity

There is currently a distinct upswing in the level of activity taking place in the oil & gas sector in South Africa. Until recently, most oil & gas interest was focused on the production area in the Bredasdorp basin to the south of the country. However, increasing attention is now being given to offshore acreage in the Orange and the Tugela basins and, perhaps most notably, to shale gas prospects that are located in the arid Karoo region in the interior of South Africa.

It has been estimated that South Africa has the fifth highest technically recoverable shale gas reserves in the world. If these reserves prove to be commercially recoverable, it will dramatically alter the energy landscape in South Africa and will act as a significant stimulus to the oil & gas industry in the country. The South African government has recently lifted its 18-month moratorium on shale gas development, and it is expected that a detailed assessment of the extent of the reserves and the development of an appropriate regulatory framework to address environmental concerns will commence shortly.

The oil & gas prospects that are currently being explored in the region pose a significant opportunity for South Africa to position itself as a major services hub for the oil & gas industry and as the ideal location from which international oil & gas companies can service their African operations. It, therefore, comes as no surprise that South Africa is in fact increasingly being used as a regional hub for oil & gas services (including fabrication and construction, repairs and maintenance, logistics) and as a base for global companies operating in sub-Saharan Africa.

## Nascent oil & gas tax rules

This renewed attention on the sector has also intensified the focus on the special tax rules that apply to oil & gas companies in South Africa. Until fairly recently, the regime for oil & gas exploration and production was contained in prospecting lease OP26. The OP26 regime expired in 2007 and special tax rules applicable to oil & gas companies were introduced by the creation of a new Tenth Schedule to the Income Tax Act ("the Act").<sup>26</sup>

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<sup>26</sup> Act No. 58 of 1962.

Broadly speaking, the aim of the Tenth Schedule is to provide an incentive for companies to invest in the high risk arena of oil and gas exploration and to create transparency and certainty for oil & gas companies in South Africa by providing a clear tax framework, both for the South African Revenue Service (“SARS”) and oil & gas companies.

#### **Special South African oil & gas tax rules**

The Tenth Schedule, which came into effect in South Africa on 2 November 2006, codifies certain aspects of the OP26 regime and also introduces some new tax principles for oil & gas companies. As noted, it aims to incentivize exploration and production, and offer fiscal stability and certainty for investment in the industry.

Although the Tenth Schedule rules are still relatively new and the interpretation of some aspects remains unclear, the regime contains some key principles that should prove attractive to organizations that are active in this sector in South Africa.

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**The Tenth Schedule rules provide that the rate of tax on taxable income attributable to oil and gas income of any oil and gas company shall not exceed 28% ...**

Some of the more notable aspects of this regime are summarized below.

#### **In general**

The Act provides that the taxable income of any “oil and gas company” will be determined in accordance with the provisions of the Income Tax Act, subject to the specific provisions contained in the Tenth Schedule to the Act.<sup>27</sup> In other words, ordinary tax principles apply but, in the event of any conflict between provisions contained in the body of the Act and the Tenth Schedule, the special rules in the Tenth Schedule will prevail.

The provisions of the Tenth Schedule regulate the taxation of “oil and gas income” of an oil and gas company. This income is defined in the Tenth Schedule as receipts and accruals derived by an oil and gas company from exploration or production in terms of any “oil and gas right.” Notably, oil and gas income also includes receipts or accruals that are derived by an oil and gas company from the leasing or disposal of any oil and gas right. Note that, unless otherwise provided in the Tenth Schedule, all other income of an oil and gas company (*i.e.*, income other than oil and gas income) is subject to tax in terms of the normal tax rules.

#### **Tax rates**

The Tenth Schedule rules provide that the rate of tax on taxable income attributable to oil and gas income of any oil and gas company shall not exceed 28% (being the current corporate tax rate applicable in South Africa) and, in the normal course, the rate of dividends tax on any dividend that is paid by an oil and gas company out of amounts attributable to its oil and gas income shall not exceed 5%.

#### **Currency gains and losses**

In terms of the Tenth Schedule, currency gains and losses of an oil & gas company must be determined solely with reference to the functional currency and the translation method used by that company for financial reporting purposes (the “functional currency” is the currency of the primary economic environment in which the business is conducted).



As a result, dollar-based oil and gas companies can use the dollar as their base currency for determining currency gains and losses for tax purposes. Furthermore, the rules provide that any amounts received by or accrued to, or expenditure incurred by, an oil and gas company in a currency other than that of the Republic of South Africa, must be determined in the functional currency of the company and must be translated to the currency of the Republic by applying the “average exchange rate” for the year.

### Tax deductions from oil & gas income

The Tenth Schedule deals with three aspects relating to oil & gas exploration and production expenditures, namely:

- operating expenditures (“OPEX”);
- capital expenditures (“CAPEX”); and
- ring-fencing rules.

### OPEX

The Tenth Schedule provides that, in determining the taxable income of an oil and gas company, there shall be allowed as deductions from the oil and gas income<sup>28</sup> of such company all expenditures and losses actually incurred in the tax year in respect of exploration and production. This does not include expenditures or losses in respect of the acquisition of any oil and gas right, but the deduction implicitly includes expenditures arising during pre-exploration and pre-production periods.

### CAPEX

In addition to claiming a deduction as OPEX under the provisions detailed above, a further deduction may be claimed in respect to capital expenditures incurred during the tax year. In this regard, the Tenth Schedule allows for the deduction of:

- 100% of expenditures of a capital nature actually incurred in the tax year in respect of exploration; and
- 50% of capital expenditures actually incurred in the tax year in respect of production.

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**As a result, dollar-based oil and gas companies can use the dollar as their base currency for determining currency gains and losses for tax purposes.**

### Ring-fencing rules

It follows from the above that all operating and capital expenditures that are actually incurred in respect of exploration or production are fully deductible for tax purposes under the provisions of the Tenth Schedule but are ring-fenced to (*i.e.*, can only be claimed against) oil and gas income.

In terms of further provisions in the Tenth Schedule, assessed losses in respect of exploration and production may only be set-off against oil and gas income, and income from the refining of gas derived in respect of an oil and gas right held by the company, to the extent that the losses do not exceed that income of the company. If any amount remains after offsetting the assessed loss against such income, an amount equal to 10% of the remaining assessed loss may be offset against any other income (*i.e.*, non-oil & gas income, such as investment income) derived by that company. Finally, any losses remaining after offset of the 10% against other income must be carried forward to the succeeding year of assessment.

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**... all operating and capital expenditures that are actually incurred in respect of exploration or production are fully deductible for tax purposes under the provisions of the Tenth Schedule but are ring-fenced ...**

<sup>28</sup> Oil and gas income is defined in paragraph 1 of the Tenth Schedule as meaning the receipts and accruals derived by an oil and gas company from:

- (a) exploration in terms of any oil and gas right;
- (b) production in terms of any oil and gas right; or
- (c) the leasing or disposal of any oil and gas right.



### Thin capitalization

In terms of current wording in the Tenth Schedule, SARS may not disallow a deduction of expenditures in respect of financial assistance that is incurred by an oil and gas company in a tax year on the grounds that the financial assistance is excessive in relation to the market value of the shares in that company unless:

- an interest bearing loan, advance or debt was owed during that tax year by the oil and gas company to a person who is a connected (*i.e.*, related) person as defined; and
- all such loans, debts and advances in aggregate exceed an amount equal to three times the market value of shares in that company.

However, it is also currently provided that where the abovementioned loans, debts and advances are considered excessive, but are only temporary, SARS may deem those loans, debts and advances not to be excessive for that period.

### Disposal of oil & gas rights

Under provisions in the Tenth Schedule dealing with the disposal of an oil and gas right, a company disposing of such a right may elect for rollover treatment or participation treatment to apply.

### Rollover treatment

This treatment can be elected if an oil and gas company disposes of any oil and gas right to another oil and gas company where the market value of the right exceeds its tax cost. In terms of an election for rollover treatment, the selling company is deemed to have sold the right for an amount equal to its tax cost. If the right was disposed of as a capital asset, the base cost of the right for capital gains tax purposes comprises the "tax cost" and if the right was disposed of as trading stock, the "tax cost" is the cost taken into account under tax rules applicable to trading stock. Essentially, under rollover treatment, any tax gain for the selling company is eliminated and the company acquiring the right is deemed to have acquired it at the selling company's tax cost.

### Participation treatment

This treatment can be elected if an oil and gas company disposes of any oil and gas right to another company where the market value of the right exceeds its tax cost. If participation treatment is elected, the selling company treats all gains on the disposal of the oil and gas right as ordinary revenue (regardless of whether the right was held as trading stock or as a capital asset) and it includes any gain in its gross income. The company acquiring the oil and gas right may deduct from its oil and gas income an amount equal to the sum included in the seller's gross income.

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Essentially, under rollover treatment, any tax gain for the selling company is eliminated and the company acquiring the right is deemed to have acquired it at the selling company's tax cost.

### Fiscal stability

In terms of the Tenth Schedule, the Minister of Finance may enter into fiscal stability agreements with any oil and gas company in respect of an oil and gas right held by that company. This agreement will guarantee that the provisions of the Tenth Schedule as at the date of the agreement (or, in the case of a right to be acquired, as at the date the right is granted) will apply for the duration of the period that the right is held.

Fiscal stability rights may be assigned as part of the disposal of an exploration or production right. Also, where a company holds a participating interest in an oil and gas right, the fiscal stability agreement will apply to all participating interests subsequently held by that company in that right. Oil and gas companies are permitted to rescind a fiscal stability agreement unilaterally if the tax law at a particular point in time is more favorable.

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... the Minister of Finance may enter into fiscal stability agreements with any oil and gas company in respect of an oil and gas right held by that company.





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