

## Global oil & gas tax newsletter

### Views from around the world

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# Spotlight on China: Investing in China’s oil and gas industry – tax trends in China

## Introduction

The oil and gas (“O&G”) sector, an exciting yet complex industry, continues to undergo significant changes, including technological development and resource discoveries.

In China, demand for energy in the past decade has surged with its fast growing economy. It has been known as a “consuming black hole” for energy imports from all over the world. Through its new 12th five-year economic development plan, China is on its way to changing that reputation. China plans to accomplish this change through restraining energy imports and encouraging domestic production via government investment in the upstream O&G industry and in energy infrastructure to meet the economy’s expanding energy demand. This includes the building of a large scale O&G producing base and the development of the natural gas sector, including shale gas.

The data contained in the table below is a snapshot of historical data and forecasts for China’s development in the O&G sector beginning in 2009.

The following article examines the common forms of investment into China that are often part of mergers and acquisitions planning and also contains a brief discussion of the O&G tax regimes in China.

## Foreign Entry: Introduction to the foreign investment industry catalogue and related trends

China has not fully opened its market to foreign investment. Certain industries, including the O&G industry, are still subject to pre-approval from the competent government authorities.

	2009	2010	2011e	2012f	2013f	2014f	2015f	2016f
<b>Oil Consumption</b>	8,538	9,392	10,030	10,592	11,100	11,600	12,081	12,540
<b>Oil Production</b>	3,996	4,273	4,127	4,214	4,350	4,443	4,443	4,461
<b>Refining Capability</b>	9,551	10,135	10,185	10,435	10,955	11,705	12,275	12,400
<b>Gas Production</b>	84.24	83.74	84.84	85.74	88.74	92.24	97.74	102.74
<b>Gas Consumption</b>	88.50	106.71	116.87	131.48	143.97	158.27	170.45	183.57

Source: Business Monitor International Ltd.  
 Historical Data & Forecasts, 2009-2016 ('000b/d)  
 e/f=estimate/forecast.

The National Development and Reform Commission and the Ministry of Commerce jointly issued the Catalogue for the Guidance of Foreign Investment Industries (“the Catalogue”) to provide guidance to foreign investors. The Catalogue has been amended from time to time, with the latest version being amended in 2011 and taking effect from 30 January 2012.

The Catalogue lists the prevailing encouraged, restricted and prohibited industries for foreign investment in China. For the categories listed as “encouraged,” the foreign investor is generally allowed to invest in and is able to enjoy certain incentives under the prevailing rules and regulations. For the “restricted” categories, the foreign investor will face certain restrictions or limitations from a market entry perspective. A foreign investor cannot participate in “prohibited” industries.

As for the upstream industries, the “encouraged” categories mainly include exploration and exploitation of coal-bed gas, exploitation of low permeability reservoirs, exploration and exploitation of unconventional oil and natural gas resources, and high risk exploration and exploitation of oil and natural gas. Foreign investment in all of these industries is limited to joint ventures. Construction and management of O&G pipelines, as well as O&G depots are also in the “encouraged” category. No downstream industries fall within the “encouraged” category, apart from the further processing of needle-like coke and coal tar. Restricted activities include the following: crude oil distillation below a set scale (*e.g.*, crude oil distillation refining below 10 million tons/year, fluid catalytic cracking below 1.5 million tons/year, continuous restructuring below 100 tons/year (including aromatics extraction), hydrocracking below 1.5 million tons/year, etc.); and the refining, wholesale, retail and transportation of crude oil and some oil products.

Compared to the Catalogue issued in 2007, new types of O&G activities such as shale gas exploration and exploitation have been added to the “encouraged” category in the 2011 Catalogue; however, certain previously encouraged foreign investment projects, such as ethylene production projects, are no longer encouraged.

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## Compared to the Catalogue issued in 2007, new types of O&G activities such as shale gas exploration and exploitation have been added to the “encouraged” category in the 2011 Catalogue . . . .

The 12th Five-Year Plan for National Economic and Social Development of the People’s Republic of China (the “12th Plan”) states the development targets for the O&G sector, particularly for the O&G trading industry. These targets include:

- (i) further improvement of the petroleum distribution system, including the following: a more reasonable layout of the distribution system; further enhancement of the service functions of retail terminals; significant enlargement of the scale of petroleum distribution enterprises; a significant increase in distribution enterprises’ strength; and the basic formation of a market pattern whereby entities with diverse forms of ownership jointly participate in the competition;
- (ii) further enhancement of the supply and support capabilities of the industry to meet the market demand for petroleum products, including improved emergency mechanisms for the supply of petroleum products and the initial establishment of a commercial reserves system; and
- (iii) enhancement of the oil market regulatory system, including the following: further improvement of regulations, standards and credit systems; a more scientific and reasonable industry administration system and methodology; a significant improvement in market players’ sense of integrity; and a more disciplined market order.

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## In most cases in the energy and resources sector, the CJV is structured as a non-legal entity . . . .

### Investment into China

Due to certain restrictions on foreign investments in the sector, inbound investments in the energy and resource sector in China commonly take the form of either a joint venture (“JV”) or a branch classified as a permanent establishment (“PE”) in China. Investment in O&G exploration and production (“E&P”) is commonly structured through a contractual joint venture (“CJV”) with a Chinese partner. The Chinese partner is normally one of the three major national oil companies (“NOCs”) in China who own the E&P rights to the oil fields. The foreign international oil companies (“IOCs”) typically enter into a production sharing contract (“PSC”) with a Chinese NOC by contributing the operating funds, equipment, and technology for its share of the oil reserves. In China, a CJV can be either a legal entity or not. In most cases in the energy and resources sector, the CJV is structured as a non-legal entity, under which the NOC and IOC operate under the same name but prepare financial statements and file tax returns separately. In this regard, the IOC may need to have its own accounting and tax personnel in China in order to comply with the relevant regulations.

In cases where the CJV is structured as a non-legal entity, the IOC is treated as having a PE in China. There should generally be no tax implications when the CJV repatriates profit back to the IOC as China does not impose a branch profits tax under the prevailing tax rules. However, when the IOC transfers its interest in the PSC to another party, gain, if any, is taxable in China. There is some controversy surrounding the applicable tax arising from a transfer of an economic interest in a PSC. Some believe that this is comparable to a situation where a foreign entity transfers its branch in China and is therefore liable for capital gains tax at 10%. Others hold the opinion that under a PSC, the exploitation and development costs are deducted for the branch’s Enterprise Income Tax purposes, such that the gain arising from the transfer of an interest in the PSC is more likely to be regarded as business profits effectively connected with the branch, and therefore taxed at 25%. It appears from discussions with competent tax authorities that the latter taxation method is likely to be adopted for the transfer of an interest in a PSC.

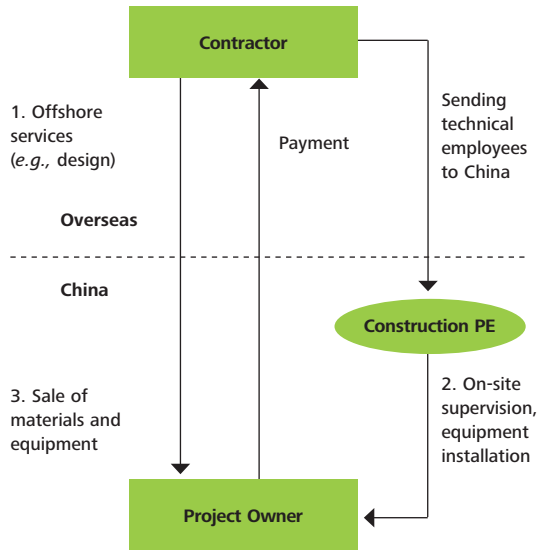
There are also restrictions on foreign investments with respect to the oil field services industry. For example, a foreign company is not allowed to set up a wholly foreign-owned subsidiary in China that engages in drilling services. Alternatively, it may set up an equity joint venture (“EJV”) in China with a Chinese partner possessing the proper industry qualifications or provide drilling services in China through a CJV.

Under the EJV alternative, the primary advantage is that the foreign company will be able to have a permanent presence in China through a legal entity. The EJV will have its own brand name, local operations, local staff, and independent accounting and tax functions. Other considerations include whether the foreign company can find a Chinese partner with proper qualifications that is willing to be bound together for the long term and whether the EJV will have sufficient contracts/projects to be profitable.

A foreign company that is a party to a CJV may send its staff into China to operate a project as a subcontractor of the project owner. According to recent tax administration regulations, a non-resident which carries out construction services in China is required to register with the competent tax bureau of the project location within 30 days of signing the service contract. The tax bureau will monitor the construction activities via the registration record until the service is completed and the fee is settled.

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**For example, a foreign company is not allowed to set up a wholly foreign-owned subsidiary in China that engages in drilling services.**



Above is a typical example of how a foreign oil field services company providing services in China is structured. The foreign company's activities would generally constitute a PE in China. The major concerns related to the taxation of this construction PE would include:

- what portion of its profits would be treated as China-sourced income and effectively connected with the PE and thus subject to China's Enterprise Income Tax at 25%; and
- the deemed profit rate to be assessed by the competent tax authority (ranges from 15% to 30%).

From a tax efficiency and business structuring perspective, holding regimes are oftentimes used when structuring acquisitions or making investments in China. With respect to structuring offshore holding companies, taxpayers should be aware that the Chinese tax authorities have focused on "beneficial owner" status when applying treaty benefits. This should be reviewed on a case-by-case basis and the State Administration of Taxation ("SAT") has issued a circular listing some factors which have negative impacts on the determination of an applicant's status as a "beneficial owner." In this regard, a pure conduit company lacking business substance is unlikely to pass the "beneficial owner" test. In 2012, the SAT issued a circular to clarify the determination of "beneficial owner" under China's tax treaties and introduced a "listed company safe harbor" that should also be considered when structuring offshore holding companies.



The Chinese tax authorities also continue to target indirect transfers via intermediate companies registered in low-tax jurisdictions. Hence, use of an intermediary holding company for tax efficient exits from China that lacks business substance may increase the risk of being audited or challenged by the Chinese tax authorities.

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### Taxation in China – Developments in recent years

The taxes and charges applicable to companies participating in the O&G industry in China primarily include Enterprise Income Tax (“EIT”), Value Added Tax (“VAT”), Business Tax (“BT”), Consumption Tax (“CT”), Resource Tax, Royalties, Petroleum Special Profit Tax, Mineral Resources Compensation Fees, and other duties and surcharges (*i.e.*, Customs Duty and City Construction and Maintenance Tax, Education Surcharges, and the Local Education Fee Surcharge, etc.) The most important of these taxes are discussed in more detail below.

### Enterprise Income Tax

Chinese resident enterprises are subject to EIT of 25% on their worldwide taxable income, pursuant to the Enterprise Income Tax Law that came into effect on 1 January 2008. Where a foreign enterprise is incorporated and managed/controlled outside of China, but has an establishment in China and engages in production or business operations, that foreign enterprise is subject to EIT of 25% on the following: income sourced within China derived from its establishment; and income sourced outside of China that is effectively connected with its establishment in China.

Taxable income is generally defined as taxable revenue less deductible expenses and/or tax losses. For O&G enterprises, deductible expenses may include reasonable production and operating expenses, tax amortization of exploration expenditures, tax amortization of development expenditures, and reasonable overhead. Certain incentives regarding qualified research and development may be available.

### Value Added Tax

A taxpayer that engages in the sale or importation of goods (goods include tangible movable property, as well as electricity, heat, and gas) or the provision of processing, repair, or replacement services within the territory of China shall calculate VAT payable based on the amount received from the sale of goods or taxable services by applying a given tax rate, generally at a standard rate of 17%.

A rate of 13% applies to specific goods such as primarily processed agricultural products. The amount of VAT payable is reduced by the amount of VAT input tax that has been paid on the purchase of goods or taxable services, as indicated on the VAT invoices issued with the purchases.

VAT is payable at 5% on the crude oil and natural gas produced from an oil or gas field operated under a Sino-foreign PSC. The VAT shall be paid in-kind and the basis for computing such tax is generally the gross production after deducting the amount of oil used for operations and depletion. The Chinese party that participates in the PSC is responsible for matters concerning the declaration of VAT or any applicable filings with the competent tax authorities.

China has launched a pilot VAT reform program in 2012 that aims to resolve the double or multiple taxation issues that arise under the current indirect tax system. The pilot program initially applies to the transportation and certain modern service industries (*i.e.*, R&D and technology services, information and technology services, creative cultural services, logistics and ancillary services, leasing of movable and tangible goods, and attestation and consulting services), which are now subject to VAT rather than BT under the pilot program. In addition to the current rates of 17% and 13%, two new tax rates of 11% and 6% have also been introduced. Geographically, the pilot program was launched in Shanghai beginning 1 January 2012 and was extended to eight other provinces/municipalities by the end of 2012. On 10 April 2013, the China State Council announced the decision to further roll out the pilot VAT program to the whole country starting from 1 August 2013. It is expected that the program will be expanded to other industries eventually.

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The pilot program stipulates that oil field services companies operating within the geographic areas covered by the pilot program and which conduct taxable activities within the pilot's scope shall follow the new pilot rules. For example, geological exploration services falls within modern services and a 6% VAT rate would apply, O&G gathering and transportation falls within the transportation industry and an 11% VAT rate would apply, and the VAT rate applicable to all the other services such as well drilling, well logging, well testing, etc. would remain unchanged.

### Business Tax

BT is a turnover tax generally imposed upon activities involving intangible goods and services which are not subject to VAT. Effective from 1 February 2012, the transfer of a natural resources use right, which refers to the transfer of the right to exploit a mine or to use the natural resources by the owner of that right, will be subject to BT at a rate of 5% in China.

With the VAT pilot program launched in 2012, the transportation industry and certain modern services industries have been moved from the BT regime to a VAT regime in pilot regions. It is anticipated to be a phase-in process at the end of which BT will be finally be replaced by VAT.

### Consumption Tax

CT is generally levied on taxpayers who manufacture, import, sell, or commission the processing of taxable consumer goods within the territory of China. For the O&G industry, taxable consumer goods are prescribed and include processed oils, which are specifically defined to include diesel oil and taxable petrol. Stable light hydrocarbons produced from the O&G manufacturing process fall into the scope of crude oil and thus are not subject to CT as processed oil products.

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The CT rates vary according to the different types of O&G products:

Tax Item	Tax Rate (RMB/Liter)
<b>Petrol</b>	
Unleaded petrol	1 RMB/Liter
Leaded petrol	1.4 RMB/Liter
Diesel oil	0.8 RMB/Liter
Aviation fuels	0.8 RMB/Liter
Naphtha	1.0 RMB/Liter
Menstruum oil	1.0 RMB/Liter
Lubricant oil	1.0 RMB/Liter
Fuel oil	0.8 RMB/Liter

### Resource Tax

Enterprises that extract mineral products, including crude oil and natural gas, within the territory of China are liable to pay Resource Tax. Effective from 2011, when a reform of the O&G Resource Tax regime was undertaken, Resource Tax is levied based on selling price rather than production volume of crude oil and natural gas, with tax rates ranging from 5% to 10%. While the pilot program was first implemented in a number of provinces located in western China in 2010, the reform finally rolled out nationwide with an effective date of 1 November 2011. Sino-foreign CJVs exploiting O&G resources onshore or offshore will be subject to Resource Tax in lieu of the existing mining royalty (please see the section below entitled "Royalty for Crude Oil and Natural Gas") from the same effective date.

The Resource Tax reform was mainly for purposes of conserving resources and reducing negative environmental impacts from mineral extraction. However, some analysts believe that this will also cause a larger portion of the profits from the resource companies to flow to the local governments.<sup>1</sup>

<sup>1</sup> Articles from Reuters (Beijing) dated 10 October 2011, "China resource tax reform to go national from Nov. 1" and from China Briefing (Magazine and Daily News Service) dated 13 October 2011, "China Kicks off National Resource Tax Reform."

## All enterprises (both domestic and foreign) that extract crude oil from the territorial land or water of China and then sell it, whether within or outside of China, shall be subject to the Petroleum Special Profit Tax . . . .

### Petroleum Special Profit Tax

All enterprises (both domestic and foreign) that extract crude oil from the territorial land or water of China and then sell it, whether within or outside of China, shall be subject to the Petroleum Special Profit Tax ("PSPT"). This tax was first launched in 2006 as part of a series of government measures to rationalize the pricing mechanism of petroleum and its products.

The PSPT was initially levied when the monthly weighted-average price of crude oil sold exceeded US\$40 per barrel. Effective from 1 November 2011, the Ministry of Finance has raised the exemption threshold of the PSPT from US\$40 per barrel to US\$55 per barrel.<sup>2</sup> This change in exemption threshold came about due to economic changes, including rising oil costs. The reform of the Resource Tax regime (described above) that also came into effect on 1 November 2011 has facilitated this adjustment of the threshold to potentially offset the additional tax burden on oil enterprises.

The PSPT specifies various progressive tax rates ranging from 20% to 40%, depending on crude oil prices. (See the table below for additional details.) Essentially, the amount of levy per barrel is calculated by taking the monthly weighted-average price per barrel sold minus US\$55, multiplied by the applicable tax rate and minus a "shortcut calculation deduction."<sup>3</sup> The levy is calculated monthly and settled quarterly.

<sup>2</sup> Circular Cai Qi [2011] No. 480 issued by the Ministry of Finance on 29 December 2011, effective from 1 November 2011.

<sup>3</sup> A "shortcut calculation deduction" is a constant equal to the difference between the amounts calculated by the progressive rates and the flat rates. It is a concept to facilitate quick calculation of taxes/levies with progressive rates.

The progressive tax rates and deductions are as follows:

Crude Oil Price (US\$/barrel)	Tax Rates	Shortcut calculation deduction (US\$/ barrel)
55 – 60 (inclusive)	20%	0
60 – 65 (inclusive)	25%	0.25
65 – 70 (inclusive)	30%	0.75
70 – 75 (inclusive)	35%	1.5
Above 75	40%	2.5

### Royalty for Crude Oil and Natural Gas

For Sino-foreign onshore PSCs, other than those located in Qinghai, Tibet, and Xinjiang provinces, a petroleum royalty is generally calculated on a block-by-block basis at progressive rates ranging from 2% (for annual gross production ("AGP") over 0.5 million tons) to 12.5% (AGP over 4 million tons). The royalty is paid in-kind with the crude oil produced and is based on the volume of annual production after deducting the volume of oil used in operations. Certain Sino-foreign onshore petroleum operations may be exempt from royalties. For example, companies whose annual production of crude oil is less than 500,000 tons and which are located in provinces other than Qinghai, Tibet, and Xinjiang are exempt. A similar royalty mechanism is applicable to the annual output of natural gas.

Pursuant to the new Resource Tax regulations issued in 2011, Chinese and foreign parties to onshore/offshore PSCs shall pay Resource Tax instead of royalties. Where a PSC for O&G exploitation is concluded before 1 November 2011, the taxpayers shall still follow the existing petroleum royalty regime during the effective period of the PSC. The taxpayers, who are mainly Chinese and foreign parties engaged in upstream O&G projects, shall begin to pay Resource Tax upon expiration of the PSC.



### Mineral resources compensation fees

According to Guotuzifa [2011] No.229, effective from 1 November 2011, Sino-foreign CJVs engaged in the exploitation of onshore and offshore O&G resources are liable for mineral resources compensation fees. However, for PSCs signed prior to 1 November 2011, mineral resources compensation fees will not be applicable within the effective period of the PSCs.

Mineral resources compensation fees, which are levied based on the sales revenue of mineral products, shall be calculated based on the following formula:

- mineral resources compensation fees = sales revenue of mineral projects \* mineral resources compensation fee rate\* recovery quotient.

The recovery quotient is defined as the extraction rate determined by the Land and Resource Bureaus and associated government authorities, divided by the actual extraction rate. The mineral resources compensation fee rate is 1% for O&G and the recovery quotient is generally set at 1 for Sino-foreign CJVs engaged in O&G exploitation.

### Withholding Tax and Tax Treaties

The withholding tax rate on passive income such as dividends, interest and royalties is 10% in China. China currently has over 90 tax treaties concluded with foreign countries and, depending on the particular treaty country involved, withholding tax rates may be reduced and can vary between 5% and 10% for dividends, between 7% and 10% for interest, and between 5% and 10% for royalties.

### Transfer Pricing

Transfer pricing in respect of related party transactions should not be overlooked as China has issued and is aggressively implementing its comprehensive transfer pricing rules.<sup>4</sup> The principal rule is that business transactions among related parties shall be priced based on the arm's-length principle. If the tax bureaus determine that the related parties failed to follow this principle, reasonable adjustments may be made by the following methods: the comparable uncontrolled price method; the resale price method; the cost plus method; the transactional net margin method; the profit split method; and other methods that are consistent with the arm's-length principle. The concept of cost-sharing arrangements is present under the Enterprise Income Tax Law and taxpayers may apply for Advance Pricing Agreements.

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### Conclusion

Overall, both Chinese inbound and outbound energy and resource investments will likely continue trending upward, both in scope and breadth. This evolving landscape, along with China's rapid economic growth, brings continuous changes in China's regulations and tax rules for the O&G industry. One of the keys to success in China will be for businesses, whether domestic or foreign, to stay informed of the trends and adapt to and be flexible with the changes.

<sup>4</sup> But for a few exceptions, taxpayers with related party transactions are required to prepare contemporaneous documentation, which is due either 31 May or 20 June depending on whether Guo Shui Fa [20009] No. 2 or Guo Shui Han [2009] No. 363 applies.

# Australia: Ongoing reform



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## **Business Tax Working Group ("BTWG") – an update**

As outlined in our last update, the BTWG released a discussion paper on 13 August 2012 considering the case for a reduction to the company tax rate in Australia, including potential measures for funding such a reduction from within the business tax system.

During consultation, the BTWG was advised of the net adverse impact these reforms, particularly those proposed in relation to the capital allowances regime, would have on capital intensive industries in Australia, including the oil and gas sector where many projects are planned or are underway.

Ultimately, the BTWG did not endorse any of the Australian Government's proposed areas for reform.

However, the Australian Government's reform agenda appears to continue, with subsequent changes that have been announced in relation to the Research & Development ("R&D") regime and a current working group that is reviewing the definition of exploration for tax purposes. These potential reforms are discussed further below.

## **Further developments regarding the Esso decision**

The uncertainty arising from the *Esso* case for Petroleum Resource Rent Tax ("PRRT") taxpayers as reported in our last update continues. The case deals with whether composite expenditures can be apportioned in working out the PRRT liability and whether taxpayers must look-through payments made to contractors (related and unrelated) to identify any non-deductible items incurred by the contractor.

Although the Australian Government made an announcement in December 2012 that it would introduce legislative amendments to address the issues raised by the case, uncertainty remains as these amendments are yet to be introduced and with the federal election looming in late September this year, it is unclear whether the amended legislation will be passed in time before the present Parliament is dissolved.

## **Further reform of Australia's transfer pricing regime**

As outlined in our last update, new transfer pricing legislation was passed by the Australian Parliament on 8 September 2012, which prescribes "treaty-equivalent cross-border transfer pricing rules" whose primary purpose is to ensure that the transfer pricing articles in Australia's tax treaties could be applied as an assessment power.

This tranche of the reforms has retrospective application from 1 July 2004.

The second stage of the reform process was initiated with the Australian Government's release of exposure draft legislation in late November 2012, containing a rewrite of Australia's current transfer pricing provisions. In February 2013, the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 was introduced into the Australian Parliament, including amendments designed to modernize Australia's transfer pricing rules. The release of the bill came a day after the OECD issued its report, *Addressing Base Erosion and Profit Shifting* ("BEPS Report"), highlighting the need for actions to be implemented to curtail base erosion and profit shifting through avenues including transfer pricing.

This provides an interesting backdrop for the evolution of Australia's transfer pricing rules, particularly given the Australian Government's decision to include reformed general anti-avoidance provisions (Part IVA) and transfer pricing provisions in the same bill.

The new transfer pricing rules, if legislated, would apply to income years commencing on or after the earlier of the date the bill receives Royal Assent, or 1 July 2013. The new laws would repeal Division 13 and Subdivision 815-A would not apply to income years to which the new laws apply. The new rules would apply both in a treaty and non-treaty context. The key impact of the new transfer pricing provisions is that the Australian Taxation Office ("ATO") would have greater authority and scope to consider cross-border transactions and arrangements in totality. In addition to considering the commerciality of such transactions, the ATO would seek to ensure that the level of profit is commensurate with the Australian taxpayer's contributions of functions, assets, and risks. This is in contrast to the language in the transfer pricing provisions that have been in place since 1982, which focus on arm's length *consideration* rather than profitability.

Stage three of the reforms involves potential change to Australia's permanent establishment profit attribution rules in line with the Authorised OECD Approach ("AOA"). Subject to the outcomes of an ongoing Board of Taxation review, it is possible that further changes to the permanent establishment rules may be made in 2013. The Board of Taxation is due to report its findings as to whether Australia should adopt the AOA in April 2013.

In an oil and gas context, some cross-border transactions/issues that raise a range of transfer pricing considerations to be aware of include:

- the establishment of offshore marketing, shipping, and procurement hubs;
- funding of foreign operations and subsidiaries;
- accidental permanent establishment risk for entities operating abroad;
- cost allocations for management, technical and head office support services;
- secondment arrangements; and
- holding intellectual property rights in Australia and conducting R&D in Australia compared to abroad.

#### **Petroleum Resource Rent Tax – technical changes**

On 13 February 2013, the Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013 was introduced into Parliament. The bill includes, among others, a number of technical amendments to the Petroleum Resource Rent Tax Assessment Act 1987.

The PRRT-related technical amendments range from minor corrections of inadvertent errors to more substantive improvements to the way in which the PRRT legislation operates, particularly for the onshore oil and gas sector (which entered the regime on 1 July 2012), although some amendments affect both onshore and offshore taxpayers. The technical amendments seek to give effect to the Australian Government's policy intent while ensuring the integrity of the rules is preserved. Various consequential amendments have also been made to ensure the PRRT legislation would interact seamlessly with other pieces of tax legislation, such as the tax administration provisions.

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**The key impact of the new transfer pricing provisions is that the ... ATO would have greater authority and scope to consider cross-border transactions and arrangements in totality.**

The key PRRT technical amendments mainly relate to:

- clarifying the manner in which the onshore PRRT consolidation rules operate;
- removing certain unintended anomalies in the operation of the starting base and look-back rules for taxpayers moving to the extended PRRT regime;
- providing an extension of time to apply for combination certificates in respect of onshore projects;
- improving the application of the functional currency rules; and
- amending the rules on exploration transfers where there have been group restructures or where permits have been relinquished.

The amendments are highly technical in nature and each taxpayer will need to carefully review their individual circumstances to identify any potential impacts from the proposed amendments.

While many of the amendments are welcome in that they would clarify certain outstanding issues, there remain several areas of uncertainty in relation to the operation of the PRRT regime, including the outstanding legislative amendments to give effect to the Australian Government's announced response to the *Esso* case (as mentioned above).

#### **ATO's review of exploration expenditure**

The ATO is currently consulting with industry as part of its review of the definition and interpretation of exploration expenditure for PRRT and income tax purposes.

The ATO expects to issue a PRRT ruling in the second half of 2013, followed by a withdrawal of Taxation Ruling TR 98/23 and the issuance of a new income tax ruling regarding the definition of exploration expenditure.

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The ATO's focus is on the ordinary meaning of exploration and it is expected this may result in a narrowing of the definition for all tax purposes; for example, feasibility costs are likely to come under much closer scrutiny to ascertain whether they fall into the ordinary meaning of exploration. This is likely to be a contentious issue and such changes could have significant impacts, such as:

- the net present value of projects could be affected as costs may be amortized over time rather than immediately deducted for income tax purposes; and
- expenditure could be reclassified as general project expenditure for PRRT purposes, reducing the amount of transferable expenditure and/or the potential uplift on amounts carried forward.

#### **Changes to the R&D regime**

The Australian Government announced further changes to the R&D regime in Australia on 17 February 2013, which are designed to better target the incentive regime to small and medium businesses.

These changes would see very large businesses with annual Australian turnovers of AUD\$20 billion or more become ineligible for any R&D tax incentives, although they would be able to claim a deduction for their R&D expenditure under general tax provisions.

The change would apply from 1 July 2013 and is only expected to immediately affect fewer than 20 corporate groups.

In addition, companies with a turnover of less than AUD\$20 million that are currently eligible for a refundable R&D tax offset would be able to receive these refunds as quarterly credits from 2014.

# India: Union Budget 2013-14 – What it means to the oil and gas sector

India announced its Union Budget 2013-14 on 28 February 2013. The Budget makes few policy announcements relevant to the oil and gas sector. The current profit sharing model under the oil and gas exploration contracts is proposed to be replaced with a revenue sharing model designed to overcome the disputes over recoverable and non-recoverable costs. With the aim being the exploitation of unconventional hydrocarbon resources, the Indian Government proposed a shale gas policy.

The key positive changes applicable to the oil and gas sector are as follows:

Proposed tax benefit	Quantum	Conditions
<b>Investment allowance</b> <b>Manufacturing sector</b> <i>(Benefit is for companies.)</i>	15% of the value of plant and machinery acquired and installed in the year in which the aggregate value of assets purchased exceeds approx. US\$20 million (INR 1 billion).	The benefit applies in respect of plant and machinery acquired and installed in the financial years 2013-14 and 2014-15.
<b>Tax holiday</b> <b>Power sector</b> <i>(Benefit extended for one more year and is for companies.)</i>	Deduction of 100% of the taxable profits, i.e., tax holiday for a period of 10 out of 15 years.	Commencement of generation or generation and distribution of power by 31 March 2014.
<b>Concessional rate of tax on dividend income from foreign companies:</b> <b>Indian company having equity holding of 26% or more in foreign companies</b> <i>(Benefit is for Indian companies with outbound investments.)</i>	Dividend received is taxed at 15% as against the general rate of 30%.	The reduced rate applies to dividend earned up to 31 March 2014.
<b>Reduction in dividend distribution tax:</b> <b>Indian company having equity holding of more than 50% in foreign companies</b> <i>(Benefit is for Indian companies with outbound investments.)</i>	Dividend distribution tax will be applicable on the dividend distributed minus dividend received from foreign subsidiaries (currently such deduction is permissible only for dividends received from Indian subsidiaries).	Dividend is received from foreign subsidiaries with equity holding of more than 50%.

The proposed amendments may increase the tax burden of non-residents if one considers the proposed increase in tax on payments to non-residents on royalty and fees for technical services. The current rate of 10% as provided in the domestic tax law is proposed to be increased to 25%; however, non-residents will still have an option to be governed by the rates provided in the applicable tax treaty provided that the non-resident has a Tax Residency Certificate issued by the foreign tax authorities in a format specified by the Indian Government and also has a tax registration number (locally known as "Permanent Account Number"). The proposed increase in rate will impact more than 30 countries<sup>4</sup> where a tax treaty provides for a rate higher than 10%, particularly with the United States (15%) and the United Kingdom (15%) being the top countries exporting oil and gas sector technology to India.

The current profit sharing model under the oil and gas exploration contracts is proposed to be replaced with a revenue sharing model designed to overcome the disputes over recoverable and non-recoverable costs.

<sup>4</sup> Australia, Azerbaijan, Belgium, Belarus, Brazil, Bulgaria, Canada, Cyprus, Denmark, Egypt, Greece, Indonesia, Italy, Jordan, Kenya, Korea, Kyrgyzstan, Libya, Malta, Mauritius, Mongolia, Nepal, Oman, Philippines, Poland, Romania, Spain, Thailand, Turkey, United Kingdom, United States, and Uzbekistan.

Non-residents providing oil field services are subject to a presumptive tax at 4% of their gross receipts. The above increase in rate will have no impact in cases where oil field services income is taxed on a presumptive basis.

The buyback of shares by unlisted domestic companies will be subject to distribution tax at the rate of 20% in the hands of a company buying back its shares. The amount received by shareholders from the company buying back shares will be exempt.

Lastly, the General Anti-Avoidance Rules have been deferred by two years and will be applicable from 1 April 2015.

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# Russia: New developments

## Industry news

- **The new mineral extraction tax rates for natural gas producers**

The Government continues mineral extraction tax indexation for natural gas producers. The new rates established for 2013-2015 have increased if compared to the rates of the previous year and are shown below. (Please refer to the July 2012 issue of the Global O&G Tax Newsletter for more detailed information.)

Natural gas (per 1,000m <sup>3</sup> )	Tax rate (RUB)			
	From 01.01.2013	From 01.07.2013	2014	2015
Gazprom and 50% (or more) affiliates	582	622	700	788
Other natural gas producers	265	402	471	552

- **Changes in export duties determination for oil products**

The new approach to determining export duties for oil products was introduced in 2011. A single export duty determined as 66% of the duty on crude oil now applies to both light and heavy oil products and as 90% of the duty on crude oil to gasoline. From 2015, it is planned that the rate for both crude oil and heavy oil products will be the same.

- **The new export duty allowance**

The new export duty allowance was introduced in January 2013 and shall come into force starting from 1 April 2013. Producers of high-viscosity oil and oil with specific physical-chemical characteristics will have the right to apply reduced export duty provided certain thresholds are met.



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A single export duty determined as 66% of the duty on crude oil now applies to both light and heavy oil products and as 90% of the duty on crude oil to gasoline.



### Non industry news

- **Research and development (“R&D”) allowance**  
A taxpayer has the right to deduct 150% of certain R&D expenses in a tax period in which the expenses were incurred, which gives a 10% cost decrease due to tax savings. R&D developments in relation to which the allowance may be applied are provided in the list approved by the Government resolution and include developments for the oil and gas industry, *e.g.* environmentally safe technologies for oil and gas production, technologies for oil and gas transportation through marine transport and pipelines, technologies to increase existing fields production, etc.
- **Thin capitalization rules related to loans received from foreign affiliate companies**  
The Russian tax legislation imposes certain restrictions on deductibility of interest charged on loans from foreign companies holding direct or indirect shareholdings in a recipient of the loan or from Russian companies that are affiliates of such foreign companies, or where such foreign entity guarantees or otherwise secures a loan. The tax legislation however does not directly restrict the deductibility of interest charged on loans from foreign affiliate companies which do not directly or indirectly hold participation in the Russian subsidiary.

The recent Russian court practice extends thin capitalization rules on loans received from foreign sister companies and confirms that the interest charged on such loans may be qualified as dividends for corporate income tax purposes. This is in line with the general Russian regulatory trend to restrain capital flight from Russia.



# United Kingdom: Budget 2013

Confidence is returning to the UK oil & gas industry and the Chancellor's recent announcements on shale gas and decommissioning certainty should only further enhance the industry's mood. Significantly, there were no surprises for oil & gas companies with the headline UK upstream tax rates unchanged. The Government has previously indicated that it would allow the various oil & gas tax measures introduced in the last two years to fully take effect before considering any further changes.

## Shale gas field allowance and ring fence expenditure supplement

The Chancellor stated at the 2012 Conservative Conference and in the Autumn Statement that the Government would launch "a generous new tax regime for shale" to encourage the development of shale gas. The recent announcement that the incentives could take the form of a new field allowance and an extension of the current "Ring Fence Expenditure Supplement" from 6 to 10 years for shale gas has indicated the likely direction for this new tax regime and will come as welcome news to the industry.

The new measures are subject to formal consultation, including whether they should be extended to other forms of unconventional onshore gas. The detailed consultation document is expected to be published before the summer and implemented in Finance Bill 2014.

Based on the limited information released, we would expect the shale gas field allowances to operate in a similar way to existing field allowances and reduce the effective tax rate on shale gas production to 30% from 62% on a proportion of the income. No details on the likely size of the allowance have been published at this stage but in practice this is likely to depend on the economics of the particular types of projects that will be incentivized.

The proposal to extend the Ring Fence Expenditure Supplement from 6 to 10 years means that expenditure on shale gas could potentially get uplifted to up to 259% of the original amount (meaning that a net benefit could accrue to the company of approximately 60% of the expenditure assuming 62% tax relief on an undiscounted basis).

The announcement also indicates that production of shale gas should remain within the general 62% ring fence tax regime that applies to other UK oil & gas production. This will be welcome news for those companies that are looking to explore for or develop shale gas in the UK and have other UK North Sea production income.

UK shale gas could make a significant contribution to the UK's future energy needs, though it is still in early stages and likely to develop slowly; however, tax is just one of a number of areas that needs to be addressed. In addition to a shale gas tax regime that encourages investment, other factors such as legal framework, environmental and local community consents, as well as developing the required technical capacity will all play an important role in ensuring the success of shale gas in the UK. To address some of these areas the Government intends to this year produce technical planning guidance, develop proposals that will allow local communities to benefit from shale gas projects in their area, and provide remit for the Office of Unconventional Gas and Oil. Taken together, these are all welcome developments for this important industry.

## Decommissioning tax relief certainty

Following announcement at Budget 2012 that the Government would introduce a contractual regime to provide certainty on tax relief for decommissioning expenditure, the recent announcement confirms that updated draft legislation and a Decommissioning Relief Deed will be published with Finance Bill 2013. Draft legislation was initially published for consultation on 11 December 2012 and it is expected that upcoming legislation will reflect the outcome of that consultation.

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Significantly, there were no surprises for oil & gas companies with the headline UK upstream tax rates unchanged.

The measures will be effective in relation to expenditure incurred on or after the date of Royal Assent of Finance Bill 2013 and Decommissioning Relief Deeds are expected to be available for signature following Royal Assent in the course of 2013.

Under the regime, the Government will have the power to enter into deeds with companies operating in the UK North Sea to guarantee the level of tax relief that will be available for decommissioning expenditure. It is hoped that the measures will release significant funds for investment if they allow companies to move to post tax decommissioning security arrangements. The Government expects additional tax revenues of £1.74 billion from the changes in the period to 2018 as a result of increased investment and production.

Key features of the draft deed include:

- a guaranteed payment from the Government if the amount of tax relief obtained for decommissioning expenditure is less than the amount due under the tax code in force at Royal Assent 2013;
- effective relief for decommissioning expenditure incurred in respect of another party's liability (as a result of default) where full tax relief might otherwise have been unavailable;
- confirmation that payments obtained under the contract will not form part of taxable profits or chargeable gains of the company for corporation tax or supplementary charge purposes; and
- targeted anti-avoidance provisions to ensure that payments cannot be obtained under contract where abusive arrangements have been entered into or where the principles of the contract have not been adhered to.

Finance Bill 2013 will also make a number of technical amendments to existing legislation to ensure that the Decommissioning Relief Deed framework operates effectively. These changes should ensure that relief for certain categories of decommissioning expenditure, including site restoration costs and onshore assets used for the purposes of offshore oil and gas production, is available under the tax code. The existing Inheritance Tax charge in respect of decommissioning security settlements will also be removed.

In addition, anti-avoidance legislation will be introduced to restrict the availability of plant and machinery allowances in certain circumstances where decommissioning services are provided by a connected party.

The announcements on decommissioning tax certainty were widely expected but are an important step on a journey that has lasted several years, with industry working with Treasury and HMRC officials to develop the detailed proposals.

### **Offshore employment intermediaries**

As already announced on 16 March 2013, the Government has confirmed that they will undertake a formal consultation on proposed measures to ensure that businesses cannot achieve a tax advantage by using offshore intermediaries to avoid income taxes or National Insurance. The Government estimates that this measure could generate up to £100 million per year.

HMRC will issue a consultation document on the design and operation of the proposed measures in May this year. Legislation expected to be included in Finance Bill 2014 envisaged that the new measures would come into force on 1 April 2014.

Although the rules are not targeted at any specific business sector, they could have a material impact on oil and gas companies as the use of offshore employment vehicles for internationally mobile workers is a feature of the industry.

### **Aligning MEAs and plant and machinery allowances for non-UK assets**

Under existing rules, there are separate regimes for assets which qualify for Mineral Extraction Allowances ("MEAs") and those which qualify for Plant and Machinery allowances. However, in what appears to be a move towards simplification, it was announced recently that the Government will enter into an informal consultation on proposals to align the treatment of assets eligible for MEAs with that for assets eligible for Plant and Machinery allowances. It should be noted that the announcement states this will only apply where profits are not taxed in the UK and it will be interesting to further understand the Government's thinking in respect of this point.

### **Other Budget coverage**

Detailed Budget 2013 coverage can be found at [www.ukbudget.com](http://www.ukbudget.com)

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If you have questions or comments regarding the content of the Global oil & gas tax newsletter, please contact one of the following global oil and gas tax leaders:

## **Julian Small**

Oil & Gas Tax Leader | Global  
*Partner | Deloitte UK (London)*  
Tel: +44 (0) 20 7007 1853  
Email: [jsmall@deloitte.co.uk](mailto:jsmall@deloitte.co.uk)

## **Harold Payne**

Oil & Gas Tax Leader | Asia Pacific  
*Partner | Deloitte Australia (Perth)*  
Tel: +61 8 9365 7202  
Email: [hpayne@deloitte.com.au](mailto:hpayne@deloitte.com.au)

## **Carlos Vivas**

Oil & Gas Tax Leader | Brazil  
*Partner | Deloitte Brazil (Rio de Janeiro)*  
Tel: +55 (21) 3981 0482  
Email: [cavivas@deloitte.com](mailto:cavivas@deloitte.com)

## **Brian Pyra**

Oil & Gas Tax Leader | Canada  
*Partner | Deloitte Canada (Calgary)*  
Tel: +1 403 503 1408  
Email: [bpyra@deloitte.ca](mailto:bpyra@deloitte.ca)

## **Alex Law**

Oil & Gas Tax Leader | Middle East  
*Partner | Deloitte Middle East (Dubai)*  
Tel: +971 4 439 4891  
Email: [alexlaw@deloitte.com](mailto:alexlaw@deloitte.com)

## **Dirk Jan van Klink**

Oil & Gas Tax Leader | Netherlands  
*Partner | Deloitte Netherlands (Rotterdam)*  
Tel: +31 8828 81323  
Email: [dvanklink@deloitte.nl](mailto:dvanklink@deloitte.nl)

## **Andrey Panin**

Oil & Gas Tax Leader | CIS  
*Partner | Deloitte Russia (Moscow)*  
Tel: +7 (495) 787 06 00 (ext. 2121)  
Email: [apanin@deloitte.ru](mailto:apanin@deloitte.ru)

## **Roman Webber**

Oil & Gas Tax Partner | UK  
*Partner | Deloitte UK (London)*  
Tel: +44 20 7007 1806  
Email: [rwebber@deloitte.co.uk](mailto:rwebber@deloitte.co.uk)

## **Jeff Wright**

Oil & Gas Tax Leader | U.S.  
*Partner | Deloitte U.S. (Houston)*  
Tel: +1 713 982 4940  
Email: [jeffwright@deloitte.com](mailto:jeffwright@deloitte.com)

## Additional local contacts for this edition

### **Andrew Zhu**

Oil & Gas Tax Partner | China  
*Partner | Deloitte China (Beijing)*  
Tel: +86 (10) 8520 7508  
Email: [andzhu@deloitte.com.cn](mailto:andzhu@deloitte.com.cn)

### **Sunil D. Shah**

Oil & Gas Tax Leader | India  
*Partner | Deloitte India (Mumbai)*  
Tel: +91 22 6185 4140  
Email: [sunilshah@deloitte.com](mailto:sunilshah@deloitte.com)

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