

Editor's introduction

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Welcome to the second edition of the Global oil & gas tax newsletter for 2018.

Oil and gas prices are enjoying a sustained recovery, and in this edition, we look at three countries that are planning to take advantage of this resurgence by updating their tax rules for upstream oil and gas activities to encourage further investment. Nigeria has been on the road to fiscal reform for almost 16 years and the current regime, with its complexities and uncertainties, is acknowledged by all parties to require fundamental changes. Unsurprisingly, it has been easier to agree that changes are needed than to agree on what those changes should be, and even within the last 12 months there has been another significant shift in the proposed approach to tax reform for the sector. Given Nigeria's economic potential, and the role that domestically produced hydrocarbons can play in realizing this potential, further delays and uncertainty hopefully will be minimized. India and Algeria are two other countries with significant upstream sectors that are starting to address the need for reform to promote investment. However, these countries are at a much earlier stage in the process.

In other articles, we look at the progress of the value added tax (VAT) implementation in the Gulf States, and we consider the changes introduced in China to promote its shale industry and commodity futures exchange. We then examine the fiscal regime for Uganda's oil export pipeline and some of the immediate consequences for the industry as a result of the United States trade policies. No doubt, this last item will have significant additional ramifications as its full impact becomes clear and we will certainly return to it in later editions.

This will be my last edition as I leave Deloitte at the end of August after 16 years with Deloitte member firms in the former Soviet Union, East Africa and, most recently, the UK. I'd like to express my thanks to all our contributors for their efforts, Joanna Lambeas for her support in the review and publication process and Chris Roberge, Deloitte's Global Tax & Legal Leader for the Energy, Resources & Industrials industry, for supporting this initiative.

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New trade friction: Impact on the oil and gas industry

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The beginning of 2018 brought a flurry of trade actions and reactions for the US and its trading partners. Several measures have been imposed by various countries, while additional measures have been announced and may be imposed in the future. For the oil and gas industry, perhaps one of the most concerning measures is already in effect. Specifically, the original steel and aluminum safeguards and related retaliation by China directly impacts imports of certain steel products vital to the oil and gas industry. This article examines some of the key actions already taken that likely directly affect industry-related products.

These actions have been adopted under the terms of existing World Trade Organization (WTO) agreements. However, not all parties agree that the actions conform to the agreements. For example, the US safeguard duties on steel and aluminum have been disputed at the WTO by China, India, Canada, Mexico, Norway and the European Union (EU). Meanwhile, during the same period, the US has initiated a dispute with China concerning the protection of intellectual property rights, in addition to implementing safeguard tariffs against a wide variety of Chinese products.

The first action to gain widespread media attention was the steel and aluminum safeguard tariffs announced by US President Trump on 23 March 2018. Under these measures, aluminum products are subject to a safeguard duty of 15 percent. For steel products, a 25 percent duty applies to a range of steel primary shapes and steel articles, including several products essential to oil and gas exploration, production and distribution. Specifically, the tariffs apply to a class of goods referred to as oil country tubular goods (OCTG), which include the following steel products:

- Line pipe used for oil or gas pipelines; and
- Casing, tubing and drill pipe used in drilling for oil or gas.

Absence of the safeguard order, these products generally are duty free upon importation into the US. However, for some countries and suppliers, anti-dumping duties already apply. For example, Chinese suppliers are subject to anti-dumping duties on imports into the US of OCTG under many of the same tariff codes as the safeguard tariffs. The new US steel safeguard duties apply to all countries except Argentina, Australia, Brazil and South Korea. These countries have reached agreements with the US to implement measures to: constrain steel imports; reduce excess steel production and excess steel capacity; contribute to increased capacity utilization in the US; and prevent the transshipment of steel articles and avoid import surges.

As a result of the additional tariffs on steel and aluminum, on 1 April 2018, China retaliated in-kind by introducing a 15 percent tariff on the same categories of US goods for import into China, plus other US goods, such as wine and agricultural products. China-based oil and gas companies, therefore, are seeing a cost increase on OCTG, although in their case it is on a smaller scale, given the volume of steel products they import from the US.



This was not the first trade action to take place in 2018. Before the announcement of the steel and aluminum safeguards in February, the US had announced other safeguard duties covering washing machines and solar cells. Solar cells are a significant and growing export product for China.

Following these initial actions, a steady stream of trade measures has been announced and/or initiated by China, Mexico, Canada and the EU. In some cases, there has been mention of potentially introducing additional tariffs, yet in other cases, the legal actions necessary to implement additional tariffs have been initiated, making these actions more likely to take effect. This raises the question of whether these trade measures are the end game, or if they are negotiating tactics in a drive toward some unspecified goal, such as improved trade relations. In public statements, President Trump has stated that the US has been treated unfairly by its trading partners and that he plans to put an end to that, and is looking for a 'better deal'.

More than 20 discrete trade-related measures have been applied to trade between the US and China that, taken individually, would have been major news a year ago. Some of these actions also impact other countries that are considering their responses, such as China's blanket reduction in duty rates for automobiles and certain retail goods. It is in this uncertain environment that multinationals now find themselves operating. The actions against drill pipe and pipeline stock inflict a direct cost on activities such as exploration, production and pipeline construction. In 2017, US importers purchased over USD 6 billion worth of these products, which now will be subject to just over USD 1.5 billion in safeguard duties. Some US and Chinese companies are feeling the impact of these new, and unexpected, additional costs already.

Companies looking for options to cope with this new environment should consider taking steps to assess their exposure to these duties and identify options for responding. These steps include:

- Studying their import data to assess the potential impact;
- Examining their current supply chains and imported products to determine what actions can be taken to manage costs;
- Examining value chain considerations;
- Scrutinizing the accuracy of tariff classifications; and
- Seeking exclusions from US tariffs or otherwise participating in the exclusion process.

We are experiencing an era of trade tension on a scale that has not been seen for decades. On July 6, an inflection point may have been reached when the US implemented safeguard duties on USD 34 billion of Chinese products for intellectual property reasons. China responded the same day with new tariffs on USD 34 billion of US products, which prompted a response from the US government that it would add tariffs on a further USD 216 billion worth of Chinese products. The next few months may provide the answer of whether we are witnessing the beginning of a wider trade conflict, or just the public negotiations of a new trade relationship between the US and China.

Algeria: Overview of the current fiscal environment

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Hydrocarbons account for two-thirds of Algeria's exports and 35 percent of its gross domestic product (GDP) according to the Organization of Petroleum Exporting Countries (OPEC). The economy, therefore, remains vulnerable to fluctuations in world commodity prices and the drop in oil prices since mid-2014 has seen hydrocarbon export revenues fall from USD 60.3 billion in 2014 to USD 35.7 billion in 2015 and to USD 27.5 billion in 2016. As a result, the Algerian government was forced to cut its spending significantly.

The last time Algeria held a tender for oil and gas blocks (in 2014), interest from foreign investors was weak and only four out of 31 blocks were awarded. To make the environment more attractive for foreign investors, in November 2017, the Minister of Energy committed to drafting a new hydrocarbon law or amending the current law. The minister confirmed on 7 June 2018 at the council of the nation (the upper chamber of the Algerian parliament) that the new version would be available at the beginning of 2019.¹ The objective is to develop and update the oil and gas resources of Algeria, with the help of foreign partners, to increase foreign exchange earnings from hydrocarbon exports.²

To the best of our knowledge, no draft of the updated law is publicly available. This article describes the current hydrocarbon law and we will describe any changes in future issues of this publication. There are a number of projects in production and the question remains of the possible impact of a new law or amendments on contracts signed under Law 05-07 and its predecessor.

Current law

Prior to 2005, research and exploration contracts in respect of oil and gas were regulated by the 1986 Hydrocarbon Law 86-14. On 28 April 2005, Law 05-07 relating to hydrocarbons, was enacted and subsequently amended by Law 13-01³ (hereafter Law 05-07). However, Law 86-14 continues to apply for oil contracts signed before 2005, subject to the option to apply Law 05-07.

The main feature of Law 05-07 is an institutional change with the creation of a national agency for the development of hydrocarbon resources (ALNAFT), a change in tax rules and a reinforcement of foreign currency regulations.

It is important to note that under both Laws (86-14 and 05-07) the participation of the state company, Sonatrach, is set at a minimum of 51 percent ownership and that foreign partners take the whole exploration risk (i.e., they may only recover exploration costs in the event of subsequent production).

ALNAFT

ALNAFT has both economic and regulatory powers. The agency promotes investments in hydrocarbon research and exploitation, determines potential exploration areas, manages and updates the databases for hydrocarbon exploration and production. The agency ALNAFT is also in charge of cost recovery audits.



1. Business leaders forum (Forum des Chefs d'Entreprise « FCE »), Press review June 10th 2018 - <http://www.fce.dz/wp-content/uploads/2018/06/revue-presse-10-juin-2018.pdf>

2. Remouche KHALED, 'Hydrocarbures : une nouvelle loi en 2018', Liberté Algérie, 3rd January 2018 (translated by the authors)

3. In french Loi n°05-07 du 28 avril 2005 relative aux hydrocarbures amendée et complétée par la loi 13-01 du 20 Février 2013

Taxation

Under Law 86-14, Sonatrach was responsible for declaring and paying oil taxes during the production period on behalf of foreign partners. Under Law 05-07, the declaration and payment of oil taxes is made at the level of the operator, which in practice is usually a joint venture between foreign partners and Sonatrach. However, each foreign partner must declare and pay any additional profit tax individually.

The main taxes applicable to exploration and production activities under Law 05-07 are the following:

- **Surface tax:** Surface tax is an annual tax based on the surface area of a block. It is paid during the exploration and production period by the operator on behalf of all partners (refer to Table 1).
- **Royalty (in French La Redevance):** Royalty is based on the production volume multiplied by the average monthly fixed price by reference to published indexes. The royalty rate is determined under the terms of each contract, although the law has fixed a minimum rate (refer to Table 2).
- **Petroleum revenue tax (in French, Taxe sur le Revenu Pétrolier (TRP)):** This income tax is based on production. Capex may be deducted following a special calculation with uplift rates depending notably on the geographical area. Operational expenditure (opex) is not deductible. The tax rate is 85 percent of gross profit for the year (as defined in the relevant oil contract), but this rate is reduced to 75 percent in zone A and 65 percent in zone B. It is payable by the operator through monthly advance installments and any balance is payable in April of the following year.
- **Additional profits tax (in French, "Impôt Complémentaire sur le Résultat (ICR)):** The ICR is based on production revenue reduced by deductions for capital expenditure (capex) and opex. The standard tax rate is 30 percent (but may be reduced to 19 percent or increased to 80 percent according to the level of profits). It is payable annually by each partner before the end of April of the year following the relevant year of assessment.

Table 1: Surface tax

Year ZONE	Research period			Retention period and exceptional period	Exploitation period
	1 to 3 included	4 to 5	6 to 7		
Zone A	4,000	6,000	8,000	400,000	16,000
Zone B	4,800	8,000	12,000	560,000	24,000
Zone C	6,000	10,000	14,000	720,000	28,000
Zone D	8,000	12,000	16,000	800,000	32,000

(Zones A, B, C and D correspond to areas of Algeria as defined by the executive decree No. 07-127. All amounts are in dinars; USD 1 = 116 dinars at the time of writing.)

Table 2: Royalty

ZONE	A	B	C	D
0 to 20,000 barrels of oil equivalent (BOE)/day	5.5%	8%	11%	12.5 %
20,001 to 50,000 BOE/day	10.5%	13%	16%	20%
50,001 to 100,000 BOE/day	15.5%	18%	20%	23%
> 100,000 BOE/day	12%	14.5%	17%	20%
Unconventional hydrocarbon	5%			

Summary of reporting and payment obligations:

Taxes	Operator	Partners	Exploration phase	Production phase
Surface tax	X		X	X
Royalty	X			X
TRP	X			X
ICR		X		X

Other miscellaneous taxes also are applicable to hydrocarbon activities, such as the gas flaring tax and tax on the use of public water resources.

In principle, Law 05-07 exempts hydrocarbon operations from VAT and customs duties, and employees of foreign oil companies are exempt from social security contributions when they remain affiliated with social security in their home country.

Foreign currency regulation

Law 05-07 has reinforced the applicable foreign currency regulations. All project-related expenses must be paid from an Algerian bank account, so it is necessary to import foreign currency into Algeria. When an operator makes cash calls to the other joint venture (JV) parties, these must be paid from an Algerian bank account. The operator must provide ALNAFT with a quarterly statement of convertible currency imports and transfers.

There is a possible exception to the application of the foreign currency regulations during the exploration phase, whereby it is possible to pay for services directly from a foreign bank account. However, the expenses must be included in the budget for the project, validated by ALNAFT and Sonatrach and duly documented. A statement indicating all these payments executed from outside Algeria with all supporting documents must be provided to ALNAFT on a quarterly basis.

According to commentators, changes could be beneficial to strengthen the development of the oil and gas industry in Algeria and there appears to be a strong commitment from the Algerian government. At this stage, there is no official information on the future hydrocarbon law or other approach to deal with issues not directly dealt with under that law that could improve conditions for the industry.



China: Income tax incentives for crude oil futures trading

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The crude oil futures market opened on 26 March 2018 in the Shanghai International Energy Exchange. Shortly before that, the Chinese Ministry of Finance and the State Administration of Taxation (SAT) jointly issued guidance (Circular 21) to clarify the income tax treatment of foreign institutional and individual investors trading in the new market, with the aim of supporting the opening of the commodity (including crude oil) futures market. Circular 21 provides the following preferential tax treatment to foreign investors:

1. Foreign institutional investors (including foreign agents) that do not have an establishment¹ in China, or that have an establishment but do not derive income effectively connected with the establishment, are temporarily² not subject to Enterprise Income Tax (EIT) on income from the trading of Chinese crude oil futures (excluding physical delivery).
2. Foreign agents that provide agency services outside of China to foreign investors are not subject to EIT on commission income arising that is not China-sourced income.
3. Foreign individual investors are exempt from Chinese individual income tax on income from investing in the Chinese crude oil future market for three years from 26 March 2018.

The same tax treatment applies to other commodity futures markets to be opened to foreign investors as approved by the State Council. While the tax exemption for foreign agents providing agency services outside of China is a clarification rather than an incentive³, the tax exemptions under items one and three above are clearly intended to attract foreign investors to participate in the Chinese crude oil futures market to promote liquidity.

The preferential tax treatment may be extended (or revoked) in future depending on market performance and the government's attitude toward foreign investors. In general, the Chinese government has eliminated most tax incentives provided specifically to foreign investors to ensure a level playing field for foreign and domestic investors in the Chinese market.

Reduced resource tax rate on shale gas

China has potentially significant, but untapped, shale oil and gas. To facilitate the exploitation of shale gas and increase gas supplies, the MOF and the SAT jointly issued a tax circular (Circular 26) to reduce the resource tax⁴ rate on shale gas from the standard six percent by 30 percent, resulting in an effective tax rate of 4.2 percent, for a three-year period from 1 April 2018 to 31 March 2021.

1. It should be noted that the concept of an 'establishment' (i.e., taxable presence) under Chinese tax law is wider than that of a permanent establishment the OECD model double tax treaty.
2. Circular 21 does not provide a specific duration for the exemption.
3. Because in most cases they will not create an establishment in China.
4. Resource Tax applies to gross sales and replaced royalty from 1 November 2011, though royalty still applies to contracts concluded before that date.

Gulf Cooperation Council: Practical impact of VAT in the oil and gas sector

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The introduction of VAT has been the most significant tax development within the Gulf Cooperation Council (GCC) member states over the past year. Businesses operating within the oil and gas sector in the Gulf region have been keenly following the development and introduction of VAT laws, and working to implement VAT across their own businesses. Our previous contribution to this newsletter ([November 2017 edition](#)) was published shortly before the introduction of domestic VAT systems in the Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE) on 1 January 2018 and analyzed key impacts for the industry and the differing approaches to applying VAT to the oil and gas sector in these two countries.

At the time of writing, the other GCC member states (Bahrain, Kuwait, Oman and Qatar) had yet to issue draft legislation or set a definite introduction date for their own domestic VAT systems, and indeed, Kuwait recently announced that its domestic VAT regime will not be in place until 2021. That said, with the remaining three GCC member states there are positive signs that the Ministries of Finance in each country are pushing ahead with the creation of necessary infrastructure, both in terms of creating the tax authorities and in drafting policies and regulations, so it would be reasonable to assume that VAT will be implemented in the near future.

In this article, we revisit four key impacts of VAT for oil and gas sector businesses in the UAE and KSA following practical experience and public guidance now available. The approach of these two major regional economies provides insight into what industry participants may face in respect of VAT across the entire GCC in due course.

1. Cash flow and compliant supplier invoicing

A design principle of most VAT systems is that VAT should not form an ultimate cost to business – with businesses in the oil and gas sector typically having a full right to “input tax” credits on VAT incurred on purchases. However, the cash flow impact of VAT throughout the supply chain can be significant.

This is particularly relevant for the oil and gas sector. Many producers, and other sector participants, have a large proportion of zero-rated export activities (in addition to a zero percent rate for domestic supplies of crude and natural gas that applies in the UAE). By charging VAT at zero percent on their sales, these businesses will often have a right to credit for VAT incurred on capital and operating expenditure each VAT period (either quarterly or monthly), exceeding the VAT charged on revenues, leaving a balance of net VAT repayable.

Although the tax authorities in the KSA and UAE have both stated that refunds of this balance of creditable VAT will be available, any cash refunds made are likely to be subject to a validation and approval process before payment is released. This may result in a cash flow inefficiency in practice and it is important for taxpayers to be aware of the potential cash flow cost.

Following the introduction of VAT, we observed that many industry participants, who had earlier calculated that they would be due a regular refund of VAT each period, discovered they would have a VAT payable balance for the initial periods. This was due in part to the time lag between receiving a supply of goods or services and the corresponding tax invoice from their

supplier that met the validity requirements to properly document the VAT credit. This cash flow effect will have been amplified during the first months of VAT's introduction due to some suppliers not being ready to issue valid tax invoices from 1 January 2018. There are particular issues to be aware of relating to supplier invoices in each country:

- In the KSA, all tax invoices must be issued in Arabic. In the oil and gas sector, most invoices had been issued only in English previously. Due to the systems challenges in meeting this new obligation, many suppliers did not issue compliant Arabic invoices initially, and many taxpayers that received English language invoices prudently delayed claiming a credit. However, in April 2018, the KSA tax authorities (GAZT) published an input tax deductibility guide, stating that where a (non-Arabic) tax invoice meets all other requirements for a tax invoice, it can be used for purposes of claiming an input tax credit. While this does not remove the requirement on suppliers to issue Arabic language tax invoices, it helps to reduce the administrative and cash flow burden for purchasers.
- The UAE requires the customer's VAT registration number to be included on the supplier's tax invoice. Suppliers have had to obtain this information and include it on all tax invoices, and this requirement has resulted, in some cases, in additional time for invoices to be fully compliant.

In both countries we have observed that, where there is any doubt over the application of VAT, suppliers are more likely to take a prudent approach and charge VAT at five percent on the transactions. However, purchasers are not able to claim a credit for VAT that is not correctly charged and this is emphasized in recent published guidance from the GAZT. Indeed, we have seen purchasers of goods and services challenging their suppliers' application of VAT in cases where there is doubt over whether VAT is correctly charged. Any delay in claiming input tax credits in these cases will affect the overall refund claims able to be made. All supplier invoices should be reviewed carefully to validate the administrative requirements, and to check the VAT imposed by suppliers is correct.

Whilst these issues do affect the cash flow of sector participants, an overall cost should not arise where invoicing can be corrected, since both the UAE and

KSA allow for input tax claims to be made in a later VAT period than that in which the input tax first became eligible. In this way, whilst supplier invoicing and other administrative issues may continue to affect the overall VAT balance during the first VAT periods, taxpayers may be able to make later claims for the initial periods of 2018 once the correct documentation has been received from the supplier. However, the potential cash flow effect of VAT should be anticipated and carefully monitored over the coming months.

2. Territorial scope of offshore activities

Neither the KSA nor the UAE have provided formal views on the territorial scope of its VAT regime to the offshore oil and gas sector. A particular issue facing the sector is the extent to which activities in each country's territorial waters or exclusive economic zone will be subject to VAT. This creates uncertainty for services physically carried out in exploration or production locations in the waters of the Gulf, and the application of VAT to these activities should be carefully considered.

Both jurisdictions link the importation of tangible goods to the formal import procedures carried out under the GCC's Unified Customs Law. This has created new VAT consequences for common commercial practices of sector participants, such as the temporary importation of production equipment, rigs and other vessels. In line with many jurisdictions, the GCC customs law allows for relief from customs duty in the case of a temporary admission of such goods for work on an offshore project. We have seen instances in the KSA where an additional five percent of the value of the import has been requested by the customs authorities as part of the 'guarantee' when temporary import relief is sought. Although the guarantee may be released when the goods are satisfactorily exported, given the high value of this equipment, this can result in a material cash flow disadvantage.

Importers should seek to understand the impact of VAT on customs guarantees and factor the funding of this into their cost modelling. Depending on the value of the customs duty payable, the cost of the guarantee and the VAT status of the importer, it may be that other commercial arrangements give a preferable overall tax and cash flow result.

3. Applying VAT to existing contracts

Globally, most contracts in the oil and gas sector are priced on a VAT-exclusive basis. However, in both the UAE and KSA, the total price payable on existing contracts that do not mention VAT and that were concluded before the introduction of VAT (i.e., the contracts did not state which party would bear the cost of VAT, or did not anticipate how VAT would affect the price) is by default assumed to be inclusive of VAT. As a result, the primary risk of the additional VAT cost on these contracts fell on the supplier.

To ensure that VAT was not a cost on contracts that were entered into before the introduction of VAT, both the KSA and the UAE introduced special grandfathering provisions that could apply to certain existing contracts. In practice, these grandfathering rules have been applied infrequently by oil and gas sector participants. The preference for many in the industry was often to agree to VAT in addition to the contract price, and manage the additional charge going forward.

The impact of VAT on engineering, construction and procurement (EPC) contracts was particularly significant given the value and duration of these contracts, as the cash flow impact of VAT was typically not included in original project modelling. Indeed, in some cases where the VAT could not be passed on, it formed an absolute cost to the supplier.

We are seeing industry participants analyzing the possibility and benefit of restructuring EPC contracts between onshore and offshore elements, which can limit the VAT cash flow impact to the value of the onshore work. However, consideration of whether a contract can result in multiple (separate) supplies, or is instead one (composite) supply for VAT purposes, is a complex area of law with limited domestic precedent. We recommend that any such analysis is approached with caution and a full analysis of the practical facts, contracts and applicable domestic legislation is undertaken.

4. Preparing for VAT in practice

Whilst VAT in the GCC is conceptually similar to VAT systems in other countries, the exercise to prepare businesses for a domestic VAT implementation is almost certain to be a significant exercise, requiring

detailed analysis and customization for each country. For international businesses operating in the GCC, our experience often has been that the local administrative requirements have been the most time-consuming aspect of the VAT implementation process.

In the KSA, the Arabic language requirements for tax invoices was a major challenge, requiring significant time and cost for international businesses to comply, particularly businesses whose enterprise reporting systems were not configured for Arabic text. Nonresident entities that are required to register for VAT can face problems with registration; for example, companies without a KSA branch must comply with local representation requirements. At the time VAT was introduced, challenges in finding approved local representatives were a significant barrier to being able to register and continue to carry on compliant operations in the KSA. We understand that there will be some changes in this area, so hopefully prospective KSA taxpayers that are impacted will have a means by which to effect a local VAT registration without having to appoint a local tax representative. Notwithstanding the proposed changes, nonresidents that are required to appoint tax representation will need to assess the impact of this on their permanent establishment position in KSA.

In the UAE, businesses are required to identify which of the seven emirates a sale is made in and report turnover relating to each emirate separately on the VAT return. In many cases, this requires businesses to introduce additional internal reporting processes. With time, we are seeing resolution of these practical issues, but we recommend businesses factor in time and resource as a contingency to deal with unexpected administrative barriers.

The tax authorities will take time to build their VAT-specific processes and sector-specific expertise. The UAE's tax authorities overseeing VAT is a newly established federal authority, separate to the existing emirate level authorities. We recommend that sector participants take this into account in their dealings with authorities, taking opportunities to share information on industry specific practices so they may develop a deeper understanding of sector specific areas and help feed into VAT policies, sector specific guidance and ongoing practice in these countries.

India: Recent tax developments in the oil and gas sector

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India is the third largest consumer of crude oil and petroleum products globally, behind the US and China. Despite the anticipated upsurge in the demand for energy and the use of renewable energy as a key focus of the government, India will continue to be dependent on conventional sources of energy—particularly hydrocarbons—for the next 20 years.

In line with the government's objective to reduce oil imports by 10 percent by 2022, several initiatives have been undertaken to increase domestic production of oil and gas and to secure resources overseas for energy security. These initiatives include:

- Completion of the mapping of sedimentary basins;
- Launch of new bidding rounds under the Hydrocarbon Exploration and Licensing Policy (HELP) and Discovered Small Fields (DSF) bidding rounds;
- Increase in refining capacity;
- Development of the national gas grid and creation of an integrated national public sector oil company; and
- Acquisition of the Hindustan Petroleum Corporation Limited (HPCL) by the Oil and Natural Gas Corporation Limited (ONGC) (completed recently).

Further, rising global energy demand has led to a wide range of opportunities for both foreign and domestic companies across all segments of the oil and gas sector, resulting in various tax issues influencing the evolution of India's tax laws. Given this scenario, we will discuss recent key tax developments impacting the sector.

Recent developments impacting the oil and gas industry

Tax exemption in relation to oil stored as part of strategic reserves

India has been pursuing the establishment of strategic oil reserves for many years. To encourage private players, such as foreign national oil companies and multinationals, to store crude oil in India and to build up strategic oil reserves in the country, the Finance Act 2016 introduced a tax exemption for income derived by foreign companies, if:

- The income arises from the sale of crude oil that has been stored in a facility in India to an Indian resident;
- The storage and sale is pursuant to an agreement/arrangement with the central government or was approved by the central government; and
- The central government has designated such agreements/arrangements as being in the national interest.

The Finance Act 2017 introduced a tax exemption granted on income derived by a foreign company on the sale of leftover stock of crude oil from strategic reserves at the time the agreement expires. To further incentivize private players, the exemption was extended by the Finance Act 2018 to the sale of leftover crude stock in the case of a premature termination of the agreement/arrangement.

Non-applicability of minimum alternate tax (MAT) in certain cases

A foreign company engaged in the business of providing services, or supplying plant and machinery for hire, to be used in the prospecting, extraction or production of mineral oils, can opt for a presumptive basis of taxation for calculation of its income, wherein 10 percent of the amount received by the foreign company will be deemed to be taxable income. The estimated income normally is taxable at a rate of 40 percent (excluding the applicable surcharge and cess) in the case of a foreign company.

The MAT is a minimum tax that must be paid by the company calculated on the book profits of the company (with certain additions and deductions) and taxed at a rate of 18.5 percent (excluding applicable surcharge and cess). Companies in India are typically liable to pay the higher of the MAT or the tax liability calculated under normal tax provisions.

Foreign companies that have elected to be taxed on a presumptive basis frequently did not maintain books of accounts, even though MAT is required to be calculated on book profits of the company. This led to extensive litigation in India by the tax authorities, with the result that foreign companies had to pay MAT. To resolve this long-standing issue and reduce the administrative burden on foreign companies, the Finance Act 2018 exempts foreign companies engaged in the business of prospecting, extraction or production of mineral oils from the scope of the MAT, retroactively from 1 April 2001.

Corporate tax rate for domestic companies

In the Finance budget 2017, the government announced the reduction of the corporate tax rate from 30 percent to 25 percent for companies with turnover of less than USD 7 million in FY 2015-16. Continuing with the government's promise to reduce the corporate tax rate in a phased manner, Finance Act 2018 has extended the benefit of the reduced corporate tax of 25 percent to domestic companies whose total turnover or gross receipts does not exceed USD 36 million during FY 2016-17. The corporate tax rates increase due to the applicable surcharge and the

levy of the health and education cess. Therefore, the effective tax rate is 29.12 percent (if turnover is less than USD 36 million in FY 2016-17) and 34.94 percent in other cases.

Introduction of limitation on interest deductions

In line with India's commitment to the OECD BEPS project, a limitation on interest deductions was introduced in the Finance Act 2017 to target the cross-border shifting of profits that affect the country's tax base. This may affect financing for infrastructure investments in the oil and gas sector, which often uses highly geared project financing structures. The interest deduction limitations are applicable to an Indian company or a permanent establishment (PE) of a foreign company in India that pays interest or similar consideration on debt issued by a nonresident associated enterprise (AE) where the interest/similar consideration exceeds USD 0.14 million.

Debt will be deemed to be issued by an AE if it provides an implicit or explicit guarantee to a non-AE lender or deposits a corresponding and matching amount of funds with the non-AE lender.

Interest will be disallowed to the extent it is the lower of the following:

- Total interest paid/payable in excess of 30 percent of its earnings before interest, taxes, depreciation and amortization (EBITDA); or
- Interest paid/payable to the AE.

However, the disallowed interest expense may be allowed to be carried forward for up to eight assessment years immediately following the assessment year for which the disallowance is first made. The deduction in the subsequent assessment year will be subject to the same restrictions.

In view of the above, foreign companies that have highly leveraged Indian subsidiaries or that have provided guarantees to a non-AE lender in respect of loans provided by third parties should consider reviewing their existing capital structures since any excess interest payment would not be allowed as a deduction for Indian subsidiaries.

Broadening of scope of “business connection” under domestic law

Under existing rules, if a person acting on behalf of a nonresident is habitually authorized to conclude contracts for the nonresident, the agent will constitute a business connection in India.

Based on the recommendations under action 7 of the BEPS project, the scope of the dependent agent permanent establishment under tax treaties is broadened under the OECD multilateral instrument (MLI), to which India is a signatory. To align Indian law with the BEPS project recommendations, Finance Act 2018 broadens the definition of a business connection under domestic law, which may impact hydrocarbon-related trading activities.

A business connection now includes any business activities carried on through a person who, acting on behalf of a nonresident, usually concludes contracts or plays the principal role leading to the conclusion of contracts by the nonresident, and the contracts are:

- In the name of the nonresident;
- For transfer of ownership or granting of the right to use property owned by the nonresident or that the nonresident has the right to use; or
- For the provision of services by the nonresident.

Further, in the context of the digital economy, the definition of a business connection is expanded to include a “significant economic presence” of a nonresident in India, whereby transactions or activities will constitute a taxable presence in India regardless of whether the nonresident has a physical presence in India or renders services in India.

Until India's tax treaties are amended through negotiation or via the MLI, companies should be able to rely on a tax treaty. Companies that are resident in countries that have not concluded a tax treaty with India may need to review their existing business models to take into account the new Indian rules. Further, with respect to the impact of the MLI, existing arrangements between related parties may need re-evaluation to consider the risks of creating a PE in India and any potential tax liability.

Introduction of general anti-avoidance rules (GAAR)

Before the GAAR was introduced in 2017, Indian courts laid down general parameters and principles for determining whether a transaction or scheme would be considered tax avoidance, tax evasion or tax planning under the income tax law. However, there were no guidelines or structured approach to ascertain whether a transaction was acceptable within the framework of the law. An expert committee was set up to finalise guidelines following a consultative process and taking into account concerns raised by stakeholders.

Under the GAAR, an arrangement entered into by a taxpayer may be deemed to be an impermissible avoidance arrangement which the Indian tax authorities can disregard or re-characterize if the main purpose of the arrangement is to obtain a tax benefit and it contains any one of the following elements:

- It is not at arm's length;
- It results in misuse or abuse of the tax provisions;
- It lacks commercial substance; or
- It is carried out in a manner that is not ordinarily used for bona fide purposes.

To implement GAAR effectively, safeguards are incorporated so that the GAAR provisions are not misused:

- A monetary threshold applies, so that the GAAR provisions will not apply to an arrangement where the aggregate tax benefit to all parties to the arrangement arising in a tax year does not exceed USD 0.43 million.
- A two-step approval process is used to help ensure that the GAAR provisions are invoked only in justifiable cases after obtaining permission from the approving panel.
- The GAAR will not be invoked merely because an entity is set up in a tax favorable jurisdiction if the main purpose of the arrangement is not to obtain a tax benefit.
- Income arising from investments made before 1 April 2017 is excluded from the scope of the GAAR.

Nonresident companies should review existing arrangements to determine whether they may fall within the parameters of impermissible avoidance arrangements because the application of the GAAR could have significant penalty, interest or reputational ramifications.

New tax on long-term capital gains (LTCG) on sale of listed equity shares or units of equity-oriented funds

A new regime for taxation on LTCGs was introduced under the Finance Act 2018. Previously, LTCGs on the sale of listed securities and equity-oriented funds were exempt from tax if the transactions were carried out through a recognized stock exchange and were subject to Securities Transaction Tax (STT). However, as from 1 April 2018, LTCGs on the sale of listed equity shares or units of an equity-oriented fund that are subject to STT are taxable at a rate of 10 percent of the capital gain exceeding USD 1,429 (without any indexation to compensate for the effects of inflation).

Although there were mixed reactions to this proposition when it was announced, the government has taken measures to mitigate the effects on existing investments, by grandfathering capital gains up to 31 January 2018.

Clarification on income computation and disclosure standards (ICDS)

The government recently notified 10 ICDS effective from FY 2016-17, with the aim of bringing uniformity to the computation and reporting of income chargeable to tax under the heads "profit and gains of a business or profession" or "income from other sources." The ICDS also aim to reduce litigation that has resulted from uncertainty. ICDS are standards which must be followed by all companies using the accrual system of accounting when computing taxable income. By introducing ICDS, companies following different methods of accounting for the preparation of books of accounts will have to compute their taxable income in line with the ICDS.

Subsequently, the Chamber of Tax Consultants sought judicial clarification on the constitutional validity of ICDS, as a result of which the Delhi High Court vide order dated 8 November 2017 struck down some provisions that intended to overrule judicial

precedents. To create certainty, domestic law was amended retroactively with effect from 1 April 2017 to bring the relevant provisions of domestic law in line with ICDS.

Compensation on termination or modification of employment

Indian courts previously have held that compensation received in connection with the termination of a business and termination of employment contracts should not be taxable if the compensation is capital in nature. The Finance Act 2018 provides that any compensation received in connection with the termination or modification of a contract is taxable as business income if it relates to a business contract or under the residual category of "income from other sources" if it is received after termination of the employment.

Extension of concessional withholding tax rate to interest payments made on rupee-denominated bonds (RDBs) and external commercial borrowings (ECBs)

The concessional withholding tax rate of five percent is extended to interest payments made on RDBs (including masala bonds) and ECBs for borrowings made before 1 July 2020. Further, a transfer of RDBs between two nonresidents should not be considered a transfer for tax purposes.

Prosecution for failure to file a tax return

Previously, prosecution proceedings for failure to file a tax return by the due date could not be initiated against a person if the tax payable on the total income determined on a regular assessment less prepaid taxes (i.e., advance tax/withholding tax) did not exceed approximately USD 43. Due to this provision, some shell companies and companies holding property to conceal the identity of real beneficiaries and not having taxable income or where withholding taxes already had been deducted, did not file tax returns. Due to the above threshold, prosecution could not be initiated in many cases.

To prevent abuse, Finance Act 2018 provides that the above threshold for prosecution does not apply to companies. Although the purpose of the measure is to target shell companies and "black money" transactions, the provisions are sufficiently broad to cover foreign

companies that take the position that a tax return is not required to be filed in India because no income is chargeable to be taxed in India or where withholding tax already has been deducted. Thus, foreign companies that earn income from India could be subject to prosecution for failure to file a return, even though the income is not chargeable to tax.

Changes to assessment procedure

The Indian government has taken steps to move from a “manual assessment” system to an electronic system. An e-proceeding facility was launched in 2017 to allow electronic examination of tax returns, and a new e-assessment procedure was formally introduced by the Finance Act 2018 that aims to reduce the physical interaction between taxpayers and the tax authorities and introduce a team-based assessment leading to greater transparency and accountability. Moving to an e-assessment procedure is in line with the government’s vision of a ‘Digital India’ and it promotes a paperless environment for assessment proceedings. This initiative is intended to make tax assessment proceedings less cumbersome and more time/cost effective without the need for the taxpayer to visit an income tax office.

Industry expectations

In the past, one of the factors that promoted investment in India’s oil and gas sector was a seven-year tax holiday, under which a 100 percent profit-linked deduction was available on eligible business carried on by an undertaking engaged in production of mineral oil and natural gas, which ceased to be available on 31 March 2017. The industry was hoping that the tax holiday would be revived or extended, in particular, to promote investment in refinery capacity. However, this has not happened, which aligns with the government’s plan to reduce the corporate tax rate from 30 percent to 25 percent, along with a corresponding phasing out of certain exemptions and deductions in an effort to move towards a more fiscally neutral tax framework.

As mentioned above, the MAT no longer applies to foreign companies that have adopted the presumptive basis of taxation and that are engaged in the business of prospecting for, or extraction/production of, mineral oils. However, the industry expectation of reduction in the MAT rate of 18.5 percent on book profits in view of phasing out of deduction and exemptions in case of domestic companies did not materialize. This could be seen from the last year’s budget where the government had said that it was not practical to abolish or reduce the MAT as the benefit to the government in terms of increase in revenue from phasing out deductions and exemptions will only be available after seven to ten years when all those who are already availing exemption at present, complete their period of availment.

So far, tax relief for capital and revenue expenditure (other than expenditure on land and goodwill) is available to companies engaged in laying and operating cross-country natural gas, crude or petroleum oil pipeline networks for distribution, including storage facilities that are an integral part of such networks. In this regard, it was expected that the government would provide tax relief to other segments of the oil and gas industry. Further, it was anticipated that losses incurred in the initial years of claiming the 100 percent deduction would be able to be carried forward indefinitely, as compared to the eight years under the current tax provisions relating to the carry forward of business losses. Neither of these changes were included in the Finance Act 2018.

Despite the increase in growth and opportunity in the oil and gas sector, very little action has been taken to address fiscal issues faced by the sector. Higher imports in the oil and gas sector leading to a higher fiscal deficit remains a concern for the government, which some argue could be addressed by fiscal measures that attract investment and raise reasonable revenue.

Disclaimer:

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*Note: Assumed USD 1 is equivalent to INR 70

Nigeria: Update on the proposed tax reform of the petroleum industry

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In the [July 2017](#) issue of this newsletter, we reviewed the Nigerian government's National Petroleum Fiscal Policy (NPFPP), which aimed to set out a road map to reform taxation of the oil and gas industry. The NPFPP was aimed at maximizing benefits to the economy in terms of increased and sustainable fiscal revenue, amongst other objectives.

At that point, we expected that the NPFPP provisions would dovetail with the anticipated Petroleum Industry Bill (PIB), which was being segmented to facilitate passage. Although the PIB has been long in gestation (over 16 years), it may soon be passed into law—the current National Assembly had promised to finalize the PIB by the end of the second quarter of 2018 but this failed to materialize.

The two previous National Assemblies had worked on the PIB without finalizing it because of various challenges, particularly its length and breadth of coverage. In their attempt to address the challenges and pave the way for eventual passage of the bill, the current Assembly has split the PIB into four major parts:

1. The Petroleum Industry Governance and Institution Framework Bill 2018 (PIGIFB), which deals with the governance/institutional aspects.
2. The Petroleum Industry Fiscal Bill 2018 (PIFB), which deals exclusively with the tax aspects of the industry. It proposes new fiscal packages (a royalty regime and tax arrangements) for the oil and gas industry and provides incentives for oil refining and the processing of gas, which are central objectives articulated in the NPFPP.
3. The Petroleum Industry Administration Bill 2018 (PIAB), which addresses the new licensing and regulatory arrangements across the value chain in the oil and gas sector. It provides a legal and regulatory framework for the petroleum industry and related matters in Nigeria.

4. The Petroleum Host Communities Bill 2018 (PHCB), which addresses the perceived causes of unrest in petroleum industry host communities. It is intended to enable host communities to benefit directly from oil and gas operations (upstream, midstream, and downstream sectors) taking place within their communities.

Of the four bills, only the PIGIFB has been passed by both legislative houses (the Senate and the House of Representatives) and, at the time of writing, is about to receive presidential assent and could become law within a few weeks.

The remaining three bills are being considered by the National Assembly and are in their second reading. The National Assembly commenced public hearings on these bills in May 2018 and will present an updated version after incorporating comments received from relevant stakeholders.

This article focuses on the PIFB, whose primary purpose is to remove provisions under the existing tax regime that militate against an efficient and effective petroleum industry. The key components of the PIFB are discussed below.

Objective and coverage

The objectives stated in the PIFB are to establish a progressive tax framework that encourages investment in the petroleum industry, balancing risks and rewards, and enhancing revenue for the federal government. These objectives are broken down as follows:

- To institute a forward-looking fiscal framework based on the core principles of clarity, dynamism, neutrality, open access and rules with general application;
- To provide a clear distinction between the tax regime (which is provided in law) and contractual obligations (which are subject to commercial negotiation);

- To establish a framework that expands the revenue base for the government while ensuring fair returns for investors;
- To simplify the administration of petroleum taxes; and
- To promote equity and transparency in the tax system.

The PIFB covers all sectors of the petroleum industry: upstream, midstream and downstream, and includes oil and gas products. Bitumen has been included under the definition of “petroleum,” which suggests that its production will be subject to Petroleum Income Tax (PIT). In the past, it was not clear whether bitumen extraction was subject to PIT or companies’ income tax (CIT).

Clearly defines administrative roles on taxes

The PIFB is intended to remove the conflict between the Federal Inland Revenue Service (FIRS) and the Nigerian National Petroleum Corporation (NNPC) over which agency has responsibility for managing royalties and concessional levies in the petroleum industry. The PIFB clearly would limit FIRS’ responsibility to the administration of PIT and CIT in respect of the petroleum industry, while the NPRC would administer royalty and concessional rents.

Single tax regime for upstream operation

Unlike the dual tax regime proposed by the NPFPP (Nigerian Hydrocarbon Tax and CIT), PIFB only proposes PIT, a single regime for upstream operations, with grandfathering for some existing projects.

The proposed PIT rates range from 15 percent to 70 percent depending on the terrain:

- Onshore: oil 70 percent and gas 30 percent;
- Shallow water: oil 50 percent and gas 20 percent; and
- Deep offshore and frontier basins: oil 40 percent and gas 15 percent.

(For these purposes, shallow water includes depths of up to 200 meters; frontier basins are designated areas that may be onshore or in deep water.)

PIT is price-based, to some extent

A company would be required to pay Additional Petroleum Income Tax (APIT) when the official selling prices exceed USD 65 per barrel for crude oil and USD 6 per million British thermal units (MMBtu) for gas. APIT rates are based on a sliding scale and will not exceed 60 percent for oil and condensate production and five percent on gas production. The official selling price would be determined by the NPRC based on published benchmarks, subject to adjustments for quality and transport costs.

A single basis for royalty assessment

The PIFB stipulates only a volume-based royalty, which is simple compared to the complex and highly technical price/value and volume bases proposed under the NPFPP.

Ring-fencing provisions

Deductions for costs would be ring-fenced to each type of terrain. Companies would be able to consolidate operations within the same terrain, e.g. all revenues and costs applicable to shallow water projects could be consolidated, but it would not be possible, for example, to use tax relief arising from exploration and development costs in a deep-water project to offset profits from shallow water production.

Local content provision

It is proposed that 20 percent of any expense incurred outside of Nigeria not be deductible for PIT purposes, except where such expenditure relates to the procurement of goods and services that are not, in the judgment of FIRS, available domestically in the required quantity and quality. This is intended to encourage companies to make use of Nigerian-made goods and services in their operations.

Interest deductibility

Any interest exceeding the London interbank offered rate (LIBOR), plus a market determined margin applicable to the industry would not be deductible. The margin would be determined on a case-by-case basis.

Removal of associated gas fiscal (AGFA) incentive

The incentive for investment in downstream gas utilization (sections 11 and 12 of the current Petroleum Profit Tax Act (PPTA)), which allows relief for both capital and operating expenditure against oil income, no longer would apply under the PIFB. Gas expenses would be relieved exclusively against gas revenue.

Restriction of capital allowance

The maximum amount of capital allowance that could be relieved in a tax year would be capped at 80 percent of the assessable profit and, any excess could be carried forward for utilization in a subsequent period. This is straightforward compared to the existing formula, which limits the deduction to 85 percent of assessable profits less 170 percent of the petroleum investment allowance.

No more preferential tax rates for new projects

The PPTA currently allows upstream operators that are yet to fully expense their pre-production expenditure to be taxed at 65.75 percent for the first five years after commencement of commercial sales of crude oil. The PIFB does not provide a preferential tax rate for new projects.

Clarity in determination of amount of intangible drilling costs (IDCs)

Under the PPTA, determination of the proportion of well costs that are IDCs (which are 100 percent deductible in the year incurred) is onerous and sometimes subjective. The PIFB fixes IDCs at 75 percent of total well cost, which would simplify the tax assessment in line with the objectives of the bill.

Incentives are performance-based

The range of PIT rates proposed are intended to reflect the costs and risks of different basins (e.g., shallow water production would be taxed more heavily than more expensive deep-water developments). The PIFB also would suspend royalties for frontier basins for three to five years as an incentive.

The PIFB would introduce a production allowance that is linked to cost efficiency (see the table below for more details). There also is a proposed Reserve Replacement Incentive (RRI) that would provide an additional production allowance to encourage more drilling activity.

Incentives to midstream and downstream petroleum operations

Midstream petroleum operations are defined as operations in Nigeria of midstream facilities, petroleum refining, gas processing, transportation and storage of petroleum products. Certain specific tax incentives are included in the PIFB to encourage investment in these sectors:

- Five-year tax holidays;
 - 10 percent investment tax allowance (meaning that a tax deduction of 110 percent of the cost incurred would be available); and
- Additional five-year tax holiday for designated “strategic” gas transportation infrastructure and distribution pipelines.

The above incentives would be available to companies that carry out the development and operation of petroleum product transportation (rail pipelines, barges, etc.) and the operation of gas processing facilities.

Although the bill does not separately define “downstream petroleum operations,” the following downstream activities would be eligible for the above incentives:

- Production and distribution of liquefied petroleum gas (LPG) and other gas-related products for the domestic market;
- Manufacturing of LPG cylinders, as well as LPG related infrastructure; and
- Operation of downstream crude oil processing facilities, including refineries, lube plants, and related infrastructure.

Periodic reviews

The PIFB provides for periodic reviews of the fiscal regime after a period of seven years. This is to accommodate amendments based on prevailing circumstances in the petroleum industry and changing economic realities.

Comparison of existing versus proposed fiscal terms

The following table compares the fiscal terms in the PPT, NPPF, and PIFB:

Parameters	PPT	NPPF	PIFB
Volume royalty	0%-20% (Oil) 7% (Gas)	5%-20% (Oil) 5%-10% (Gas)	5%-20% (Oil) 5%-10% (Gas)
Value royalty	N/A	0.2% per USD above USD 50 oil price; capped at 20%	N/A
Petroleum tax	PPT: 50%-85% (Oil)	Nigerian hydrocarbon tax: 20%-30% (Oil) NHT: 0% (Gas)	PIT: 40%-70% (Oil) PIT: 15%-30% (Gas)
APIT	N/A	N/A	0.5% increase in (APIT) per USD 1 increase in oil price above USD 65 per barrel. Capped at 60%
CIT Act	30% applicable to gas production	30%	N/A
Capital allowance	Five-year straight line (SL) with 5%-50% investment tax credit. Limited to 85% of assessable profits	Five-year SL, limited to 80% of assessable profit	Five-year SL, limited to 80% of assessable profits
Production allowance	N/A	For quantities \leq 50MMbbl: USD 3 – USD 7/bbl	Minimum of 30% of oil price or USD 3. 50%-120% adjustment depending on cost efficiency
Cost efficiency factor (see note 1)	N/A	N/A	OPEX price ratio = 20%
Reserve replacement incentive	N/A	N/A	Additional production allowance of 50%-120%
Tax inversion penalty (see note 2)	N/A	Cost price ratio = 30% Tax inversion penalty	N/A

Note 1:

This is defined as the ratio of 20 percent of total revenue to total operating costs (i.e., 20 percent revenue/OPEX). A company entitled to a production allowance would be able to claim the production allowance only to the extent of its cost efficiency as determined by the cost efficiency factor set out below:

Cost efficiency factor	PA applicable factor
CEF <= 0.5	50%
0.5 < CEF < 1.2	50% to 120%
CEF >= 1.2	120%

Note 2:

Another proposal would encourage cost efficiency whereby cost above a certain threshold would be disallowed for tax purposes.

Reactions

Industry participants have raised concerns about the proposals included in the PIFB. For example, whilst it is widely acknowledged that Nigeria could utilize its gas reserves more effectively to boost the country's electricity supply, the PIFB provisions for

gas production are considered more onerous than the existing law and, hence, are unlikely to encourage gas developments. A second area of concern is the imposition of royalties on strategically important deep-water oil production, which currently is exempt. The saga of fiscal reform of Nigeria's hydrocarbon sector is not complete.



Uganda: Fiscal framework for the East Africa crude oil pipeline

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The construction of the East African crude oil pipeline (EACOP) is a key step towards large-scale production of Uganda's oil discoveries. The EACOP project involves the construction of a 1,445 km crude oil pipeline that will transport Uganda's crude oil from Hoima, where the oil fields are located, to the port of Tanga in northern Tanzania.

A significant step towards the start of the project was the signing by Tanzania and Uganda of the Inter-Governmental Agreement (IGA) for the EACOP project on 26 May 2017. The IGA followed months of negotiations after a decision by the Ugandan government in 2016 to select the Hoima-Tanga route, instead of the generally expected route through Kenya. The decision was made on the basis that this route provided the lowest cost (at an estimated tariff of USD 12.20 per barrel), as well as the tax incentives offered by the Tanzanian government. The IGA is a bilateral agreement that covers aspects touching on the acquisition and grant of land rights, the free flow of foreign currency, including an exemption from any restrictions applicable to payment in a foreign currency or holding of foreign currency accounts whether within or outside the two countries, and the free movement of personnel, goods and services. It also has specific and detailed rules for the taxation of the project. The investors in the project are not parties to the IGA and it is expected that host government agreements (HGAs) will be entered into with the investors by the respective states as the project moves towards execution. The IGA envisages a single project company owning and operating the pipeline across both states. This entity may be incorporated in one of the two states, or in a third jurisdiction, and may operate through branches or subsidiaries.

Uganda and Tanzania are members of the East African Community (EAC, which includes Burundi, Kenya and Rwanda), which forms a customs union, but does not currently have an effective multilateral tax agreement, which leads to the risk of double taxation for cross-border transactions within the EAC. The EAC countries have signed the East African Community Double Taxation Agreement (EAC DTA), which was approved by the EAC Council of Ministers in 2010. However, to date, only Rwanda has ratified the treaty, so it is not effective. As a result, an important function of the IGA is to minimize the risk for investors in the EACOP project of activities being taxed in both Uganda and Tanzania.

The signing of the HGAs, together with the IGA, should clarify the tax treatment of the project in both jurisdictions. The provisions of the IGA and HGA, when signed, will have a retroactive effect on activities undertaken prior to their coming into effect. The IGA provides for the following in respect of the taxation of the project both in Uganda and Tanzania:

Corporate income tax (CIT)

- Project revenues and expenses are to be allocated between the states to determine the base for CIT. The basis of allocation is to be set out in the relevant HGAs and is to avoid double taxation by ensuring that no cost or revenue is to be allocated to more than one jurisdiction (and this principle is to apply to other applicable taxes).
- Income from owning and operating the EACOP is exempt from CIT for 10 years from the date of the first commercial transportation and export of petroleum.

- Depreciation allowances for the capital costs of the project are five percent per year on a straight-line basis.
- Losses may be carried forward indefinitely from the year the losses are incurred (which includes the 10-year exemption period) provided they are used only to reduce chargeable income in any year by a maximum of 70 percent.
- Tax credits will be available for domestic and foreign income tax suffered on income, and may be carried forwards indefinitely against CIT on foreign income in subsequent periods.
- Project participants and affiliates of a shipper or investor that sells for export or, exported petroleum will be taxable only in the countries where they are resident or have a permanent establishment.
- CIT relief on decommissioning costs is to be provided in accordance with the HGAs but there is no indication of which principles are to be applied in those agreements.
- As noted above, the IGA contemplates that the EACOP may be operated via branches of the project company. It indicates that branch profits tax may be applicable to repatriated (or deemed repatriated) tariff income, but does not provide details. This is to be addressed by the relevant authorities in Tanzania and Uganda once the project company structure is finalized.
- The IGA does not address the issue of thin capitalization, although typically such projects may be highly leveraged. In the absence of explicit rules under the IGA or HGAs, it may be assumed that relevant domestic rules would apply.

Withholding tax

- A 10 percent withholding tax will apply on payments of interest to a lender that is a shareholder and zero percent on other financing parties as specified in the HGAs.
- A withholding tax will be applicable on the supply of technical and other services provided directly and exclusively to the EACOP project.
- No withholding tax will be applicable on tariff payments and the import of goods and supply of petroleum for the direct and exclusive use of the EACOP project.

VAT and customs duties

- The states are to ensure that VAT is not an economic cost to the EACOP project by treating VAT as deemed to be paid for the three years of construction, or as extended in the case of disruption and for Tanzania after the construction period, where a refund of VAT is applicable. Refunds will be due within 30 days and interest at the Bank of Tanzania prevailing discount rate will be applicable if the refund is not made. (Uganda has VAT deemed paid provisions in its legislation for government-funded projects; this category will include the pipeline. Hence, unless the law changes, there would be no reason why a VAT refund would arise in Uganda).
- No VAT will be applicable on the supply of transportation and incidental services by the project company.
- No VAT will be imposed on the import of goods and services provided directly and exclusively for the EACOP project by the project company, its contractors or their subcontractors.
- Import taxes should not be an economic cost to the project. This is to be achieved via an exemption from customs and other import taxes on the following items for exclusive use on the project: machinery and other inputs (excluding motor vehicles), capital goods and the temporary importation of motor vehicles. Additional clarifications are to be provided in the HGAs.

The statement that VAT will not be applicable on the supply of transportation is vague and leaves room for misinterpretation. It remains to be seen whether this means that a refund will be possible where VAT has been charged and whether the VAT provisions in the partner states will be amended to exempt or zero rate such services. Further administrative details are to be set out in the HGAs, which will provide for specifics relating to:

- Tax relief to the project company for the cost of decommissioning the EACOP system; and
- The process for filing VAT refund claims, invoicing, and the payment of VAT and control procedures.

Transit fees

- The IGA provides a comprehensive exemption from transit fees and similar levies on pipeline throughput.



General provisions

- The tax treatment of the transfer of assets related to the project in each jurisdiction is to be addressed in the relevant HGA.
- Accounting, tax computation/returns and payments may be carried out in US dollars. This will be important to investors given the perceived volatility of local currencies.

It should be noted that both governments have emphasized the development of local content. The IGA requires cooperation between the governments to harmonize the individual country's local content policies and develop and agree on a national content plan for the EACOP project. The project company, contractors and

subcontractors are required to include national content as one of the evaluation criteria in the bidding process. However, there is no proposal to restrict tax relief for non-local goods and services.

The importance of the EACOP project to Uganda is underscored by the 2018 amendment to the income tax act to give the IGA the same status as Uganda's double tax agreements. Tax provisions in the IGA will take precedence where there is conflict with the provisions of the tax law. As in the case of tax agreements, this is not applicable where the resident of the other country taking benefit is not a beneficial owner of the income being received and does not have economic substance in the country of residence. At the time of writing, similar steps had not been taken in Tanzania.

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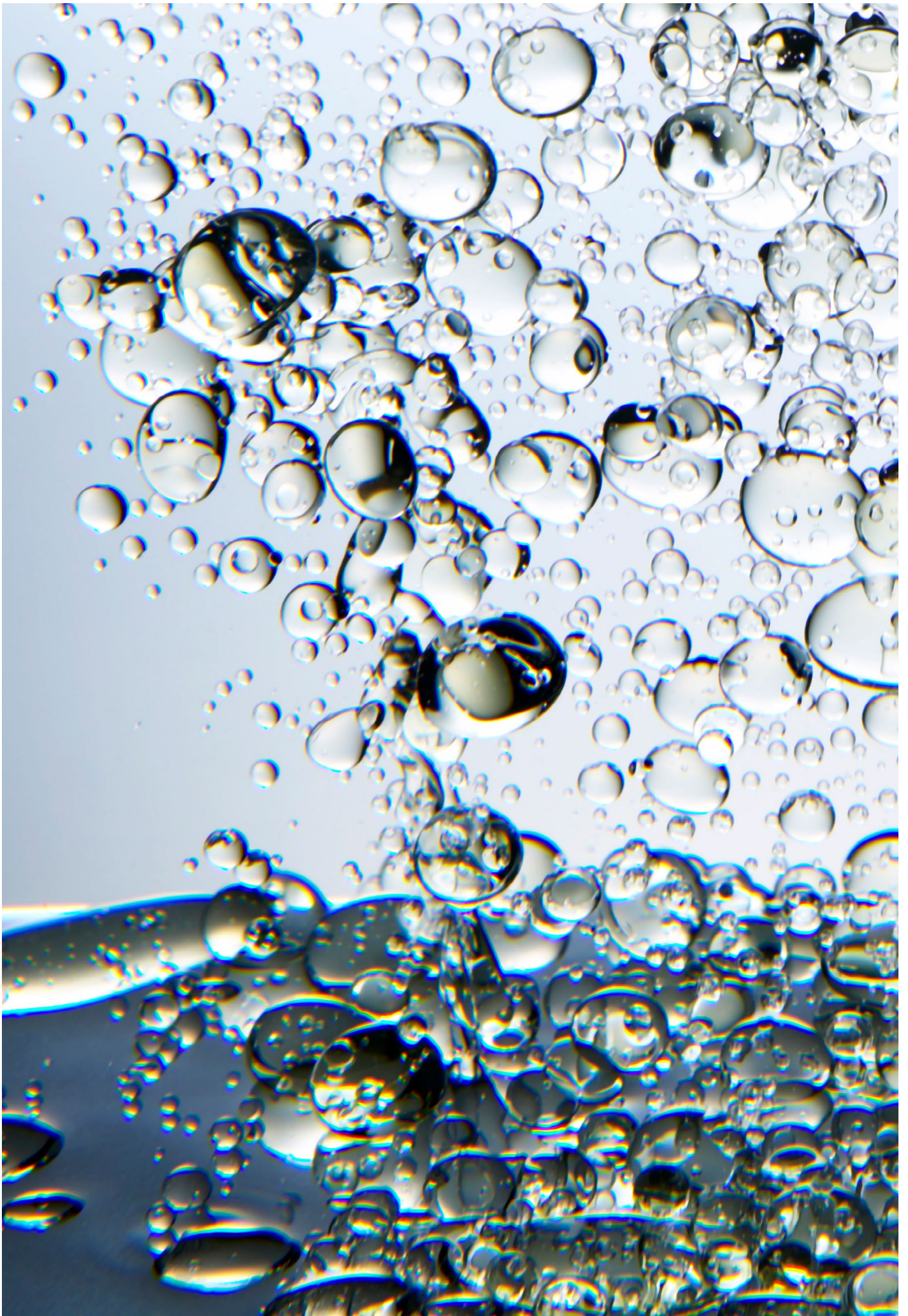
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