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## In this issue



# Global oil & gas tax newsletter

Views from around the world

July 2019

# Message from our Global Oil, Gas & Chemicals Tax Leader, Deloitte Touche Tohamatsu Limited


# Editor's introduction

## Miriam Wray, Deloitte UK

Welcome to the latest edition of the Global oil & gas tax newsletter.

Governments have continued to respond to the reduction in oil prices in recent years in a variety of ways, depending on the location and economic maturity of their oil and gas assets. In this edition, Mario Nascimento and Renata Britto provide an overview of the upstream regime introduced in Brazil in 2018 that aims to encourage more investment in upstream assets.

The UK government is working with industry to help the UK become a leader in decommissioning, and Simon Lee outlines the changes in the UK tax provisions that introduce the ability for companies to transfer their tax history. There are a number of investors specifically interested in end-of-life assets, and these changes should increase the number of economically viable decommissioning projects in the North Sea. Xheni Kakariqi looks at the history of the oil and gas tax regime in Albania, as well as the proposed changes to the legislation.

As oil and gas companies are considering how to implement SAP S/4HANA, Roman Webber and Shann Bhat outline some of the opportunities available to tax departments in the design phase of such a project and considering how the work of the tax function will change over the next few years.

We also report on some of the ongoing work in the international arena, including the latest from the Platform for Collaboration on Tax on its work in developing a toolkit to assist countries in addressing the challenges of taxing gains on offshore indirect transfers of assets (OITS). Finally, we comment on the OECD consultation on addressing the tax challenges of digitization on the economy.

We always welcome suggestions from readers for topics they would like to hear more about in future editions, so please email me at mbwray@deloitte.co.uk with any requests.

# Taxation of offshore indirect transfers

In the November 2017 edition of this newsletter, Bill Page reported on the work of the Platform for Collaboration on Tax ("Platform") in developing a discussion draft of a toolkit to assist low-income countries in addressing the challenges of taxing gains on offshore indirect transfers of assets (OITs). The Platform was set up by the OECD, the International Monetary Fund (IMF), the World Bank Group and the United Nations (UN) following the 2014 report for the G20's Development Working Group to address the top priority BEPS issues identified by developing countries. On 1 August 2017, a discussion draft of the OIT toolkit was published, inviting comments from interested parties by 25 September 2017, with the expectation of producing a final toolkit by the end that year.

Our previous article set out the history and importance of the toolkit, originally promised in the 2014 report for the G20's Development Working Group, and outlines in detail the structure of the draft toolkit, the tax and non-tax arguments for the use of OITs in general, consideration of whether capital gains on OITs should be taxed and which country should have primary taxing rights. The article also set out the two models proposed for taxing gains, with model one being that entities located in the relevant jurisdiction be treated as disposing and immediately reacquiring, at market value, all of its assets and liabilities, and model two treating the transfer as being made by the actual seller offshore, but sources the gain on the transfer to the location country to enable that country to tax it. The draft toolkit considered the implications of tax treaties with respect to these proposals, as well as the recommendation to adopt the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI).

We also highlighted a number of issues that could arise from the initial draft toolkit, including the valuation of the assets in practice, the treatments of costs, currency gains and the disparity of taxing reorganizations and reinvestments under the two models. The article concluded that a coherent approach internationally may prove challenging, reflected by the number of options suggested in the toolkit, together with the fact that countries have already begun introducing relevant legislation.

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### Toolkit version 2

Following the comments on this first discussion draft, a second draft was published in July 2018 along with the detailed comments received from 19 groups, each representing a much larger number of entities. Further consultation on this revised draft was invited with a deadline of 24 September 2018, with the aspiration of producing a final toolkit by the end of 2018. The Platform published the comments received from 12 organizations in October 2018 and the final toolkit is still to be published.

### Comments on the initial toolkit and the changes made in the revised draft, version 2

Many of the responses on the initial toolkit sought clarification of the purpose and the status of the proposed toolkit, highlighting concern in potentially proposing significant changes to taxing rights between source and residence countries. There were queries as to whether the Platform was a suitable multilateral body for such decisions. The following clarification is made at the end of the Introduction to the revised Toolkit:

> This report and toolkit does not purport to provide binding rules or authoritative provisions of any kind nor does it aim to establish an international policy standard of any kind. Rather, it is intended to describe an international taxation issue of particular concern to developing countries, and to provide practicable guidance to them on options for how to address that issue, should they choose to do so. As such, the report represents the analysis and conclusions of the tax staffs of the four partner organizations and does not represent the official views of the organizations' member countries or management.

Most comments on the consultation raised objections to the fact that the initial draft expressed a preference for model one, and argued that the preference was not sufficiently argued with respect to evidence available. Arguments put forward in favor of model two include the fact that it is more in line with tax treaty perspectives and that it is better to tax a real, rather than deemed, transaction. Arguments against model one include a higher risk of double taxation, the fact that the company suffering tax has not received the sale proceeds and that a transfer of funds to settle any tax liability may be a challenge especially when there are minority shareholders. The introduction to the revised draft heralded the change in opinion that favored method one and instead states that it "does not set out a single, definitive approach suitable in all circumstances."

Respondents also highlighted a concern that the initial toolkit published in 2017 had an inherent bias that indirect holdings often are used as part of a tax avoidance strategy, ignoring the fact that OITs generally are commercially motivated transactions, and some developed countries such as Norway and the US do not tax them. The potential impact on foreign direct investment also was highlighted and the economic rationale for taxing OITs was challenged. The language and tone of the revised draft has been modified throughout.

Some respondents suggested that the scope of the initial toolkit could be extended to movable and immovable property, which was not adopted in the revised draft. However, some respondents commented that the definition of immovable property given already was too broad or uncertain, moving away from existing treaty definitions. Many responses looked at the arguments around location rents and suggested that alternative measures could be considered. One response specifically compared the terminology relating to intangibles and location rents with that used by the OECD and UN in the area of transfer pricing. There have been some clarifications introduced, but no substantial changes.

Several respondents on the initial toolkit felt that the document failed to address the complexity of taxing OITs. The response of the Platform was to indicate that the model provisions included in the draft toolkits represent a simplified set of legislative provisions that do not purport to deal comprehensively with more complex issues such as corporate reorganizations, minority shareholders, joint venture arrangements, valuation difficulties, listed securities, the treatment of losses and other double taxation issues that can arise. The revised draft now looks at some of these areas whilst noting that any provisions adopted by a jurisdiction will need to be adapted to reflect the individual circumstances of the country concerned, including its domestic and international tax policy settings.

### Comments on the revised draft, version 2

The Platform published the 12 sets of comments received on its revised draft in October 2018. As with the comments on the previous draft, the comments represent a broad range of interests and entities. Whilst respondents acknowledged that the previous consultation had resulted in improvements to the toolkit, there were areas where it was felt that the toolkit could be enhanced.

In particular, there was a concern on the part of business representatives that if the toolkit became too general and avoided some of the complexities of common commercial scenarios, such as reorganizations and minority shareholders, the rules could be implemented without full consideration of the issues involved. This could lead to inconsistency, increased uncertainty, double taxation and more disputes. There were suggestions that additional guidance on how to value transfers and calculate the gains/losses with worked examples would be beneficial. Respondents also felt that whilst there were drafting changes that softened the preference for model one, there was still an unevenness around the analysis of both models.

## What's next?

The decision on whether and how to tax OITs is an important policy decision, especially for countries with significant natural resources. The draft's status as guidance from the staff of the Platform member organizations may indicate that there is less chance of international consistency, and jurisdictions continue to introduce and update legislation in this area resulting in a greater risk of double taxation. Having missed the target of publishing a final toolkit by the end of December 2018, the Platform has not yet given an update as to when they hope to publish it. This may give hope to those parties wanting more detail within the document.

# OECD consultation on addressing the tax challenges of digitization on the economy

On 31 May 2019, as part of the ongoing work of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting, the OECD released a Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy.

The program, following the policy note released on 29 January 2019 and the public consultation document released on 13 February 2019, sets out the work to develop proposals under two 'pillars':

- Pillar one: Revising nexus and profit allocation rules to address how taxing rights should be allocated among countries and, in particular, to market countries
- Pillar two: A global anti-base erosion proposal to strengthen countries' ability to tax profits where income is locally subject to a low effective rate of tax.

These proposals represent potential fundamental reform to the international tax framework and are not limited to highly digitalized businesses. All businesses operating with extractable natural resources should consider how these proposals could affect them.

The Deloitte Alert of 4 June 2019 gives more information on the proposals.

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# Getting ready for an ERP implementation

This article looks at the challenges facing tax departments due to changes in the use of technology, both within the companies themselves and within the tax authorities auditing them. Many oil and gas companies are going through an ERP upgrade and one of the most commonly used systems in the sector is SAP. For illustrative purposes, this article will focus on S/4HANA functionality and our experiences. The article considers some of the opportunities this upgrade presents to the oil and gas sector, its implications for tax departments specifically and suggests how tax functions could approach its implementation.

## Global tax administration trends

Tax administrations around the globe increasingly are looking at the challenges of getting accurate data fast. Tax administrations also have been concentrating on the opportunities provided by big data, and the impact it can have on their audit approaches both for direct and indirect taxes.

For example, in Australia, the Australian Tax Office has been recruiting experts in big data to assist with its audit risk-based approach. In Europe, several tax authorities have moved towards e-audits and the delivery of a standard audit file for tax to tax authorities. In Brazil, the filing of corporate tax returns was eliminated in 2014 because the tax authorities already held large amounts of the required data. In China, new regulations require large taxpayers to grant the tax authorities increased access to their internal tax risk control systems. In Singapore, the tax authorities are looking at how technology tools can be used to e-file returns.

## Technological trends within businesses

Our recent Deloitte Insights paper, Building the tax function of tomorrow – today, looks at some of the pressures facing tax functions across all industries when navigating the digitization of the business, and responding to internal demands to become increasingly efficient in terms of costs and delivery. This article is recommended to those leading a tax function as it sets out some areas where strategic thinking could add significant value to the tax function and the business.

One of the significant changes that we are seeing across a number of oil and gas companies is the implementation of SAP S/4HANA, the latest version of the SAP Enterprise Resource Planning (ERP) system. It comprises various products, including the platform itself, as well as databases. It enables tax functions to use real-time analytics and to run applications on large volumes of detailed data from virtually any data source. All of these applications are interconnected, making it possible to access and use detailed data from anywhere within the company in real time.

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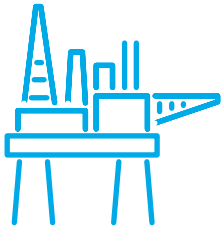

Significant changes from previous versions, such as SAP ECC, include the following:

- **Simplified Data Model** – There are significant improvements around the quality and quantity of records kept within S/4HANA. For example, customers, vendors and partner functions such as sold-to party andbill-to party will be maintained as business partners, eliminating redundant data objects by avoiding duplication. The Universal Ledger ensures that all financial entries are recorded in a single table providing better insight across the various modules. The entries will be used from all sources, such as the General Ledger, profitability views, material ledgers and asset accounting, ensuring that the same underlying data is used across all financial reporting and planning processes.
- **General Ledger** - Cost elements, which were maintained as a separate module, have become part of the Chart of Accounts and are maintained in General Ledger account master data. This will allow tax functions to determine the tax treatment of individual items of expenditure more easily and move key tax controls to an earlier point of the process.
- **New Parallel and Extension Ledgers** – The new ledgers facilitate dual ledger reporting, which should be helpful, for example, in joint venture accounting. The Extension Ledger provides different management views/simulations directly from the underlying data in the Base Ledger.
- **Enterprise Performance Management** – Tax functions will have real time access to data with the ability to drill down to see underlying transactions.

SAP Fiori is the new SAP User Interface (UI), which has a modern web-based design, allowing users to drill back to the source data directly from the app. There is an evolving set of applications available "out of the box" and these can be custom built as needed.

### Direct tax processes

Direct tax processes have not been an area of focus within SAP S/4HANA, although it is clear that the Universal Ledger will signifcantly reduce the manual reconciliations currently required between SAP modules. Due to the different country requirements for direct tax reporting, it still will be necessary to use a local software solution for direct tax compliance. With respect to operational transfer pricing, there is improved functionality for valuing the transfer of goods and services which allows parallel valuation methods according to the legal entity, group or profit center. The group reporting functionality aims to reduce the burden on period-end close.

### Indirect tax processes

SAP Global Tax Management provides a holistic approach to the calculation and reporting of indirect taxes. This process aims to help companies manage indirect taxes consistently and cost effectively, enabling tax functions to adapt to rapidly changing regulations around the world. By using a single source of data, indirect tax calculations and returns will require minimal tax function intervention. The framework also allows for integrated communication with government gateways to complete the statutory filings.

### Data Management and Storage

With the introduction of SAP HANA Data Management Suite, tax functions will find that there could be substantial benefits in storing, refining and enriching data in a single system resulting in easier tax return compliance. Being able to process the data at source reduces the need for manual intervention. The data management suite, specifically in creating static data, will be help create data sets for tax audits, and will enable tax functions to share the tax history on entity carve outs and dispositions.

### Implications for the tax function

A SAP S/4HANA implementation is an opportunity to look at where the tax function can add most value.

Tax professionals can often add most value in the design of the tax control system, real time tax planning and managing controversies, rather than the traditional reporting and compliance roles. As tax authorities move closer to the source data, the tax function will need to begin thinking more about how it can ensure the data is correct in the source systems from the start, with benefitsnot just confined to the compliance process, but also from the use of embedded analytics using SAP Analytics Cloud which will provide insight around simulations and forecasting.

As oil fields and assets come to the end of their useful life, and decommissioning commences, having accurate data for planning will be necessary. Emerging digital technologies are only as good as the data they have to work with and there can be significant rewards from investing time assessing what data is available and, where necessary, building on it. All existing SAP systems will have to migrate by 2025, and tax functions should ensure they are involved from the outset.

# Brazil: Tax legislation for exploration and production activities

New tax rules for exploration and production (E&P) activities in Brazil took effect on 1 January 2018.

Provisional Measure No. 795/2017 (PM 795) introduced new corporate income tax deduction rules for E&P expenditure and amended the tax treatment of cross-border charter remittances (e.g. bareboat charter and leasing of a rig). PM 795 was converted into Law No. 13,586/2017 (with some modifications) on 29 December 2017.

## New income tax rules for E&P

The rules governing the tax treatment of expenditure incurred in exploration and production oil and gas activities are revised to allow taxpayers to take an immediate full deduction from taxable income for expenses incurred on certain activities aimed at the exploration and discovery of oil reserves.

Before Law No. 13,586/2017 (and before enactment of PM 795), the deduction for income tax purposes typically would follow the accounting recognition of expenses, based on the successful effort or full cost methods, and there were instances where the Brazilian tax authorities challenged the deduction of expenses taken under the successful effort method.

Normative Instruction No. 1,778/2018 (NI 1,778/18) listed the activities that may generate deductible expenses during the exploration phase, including:

i. Acquisition and processing costs of geological and geophysical data;

ii. Topographic, aerial, geological and geophysical studies and surveys, including the interpretation of such studies and surveys;

iii. Drilling for the evaluation and identification of areas of oil reserves, and the acquisition of related equipment;

iv. Abandonment of exploratory wells;

v. Execution of training and production tests for the evaluation of the discovery; and

vi. Implementation of the facilities required to support the activities set forth in items i to v above, including expenses for services and civil engineering work and infrastructure in the onshore exploration phase.

The exploration phase is defined as the period from the time the concession agreement is signed until the earliest of the following:

- The expiration of the contractually defined term with the National Agency of Petroleum, Natural Gas and Biofuels (ANP);
- The devolution of the full area of the exploration block; or
- The conclusion of the evaluation of the commerciality of the area referring to a producing field.

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Additionally, companies may take accelerated depreciation of assets used in development activities indefinitely. Accelerated depreciation is determined by using the units of production method multiplied by 2.5. Once the asset is fully depreciated for tax purposes, the accounting depreciation expense should be added-back when calculating income taxes for the period.

NI 1,778/18 provides that development phase activities include:

- Studies associated with project planning and implementation,
- Obtaining licenses to implement the project;
- Drilling and completion of production and injection wells;
- Construction of oil and natural gas extraction, collection, treatment, storage and transfer facilities;
- Construction of offshore platforms, pipelines, oil and natural gas treatment units, wellhead equipment, production lines, flow lines, tanks and other installations exclusively intended for the extraction; and
- Construction of oil and gas pipelines.

The development phase starts with the Declaration of Commerciality and may exist simultaneously with production activities.

The changes introduced by Law 13,586/2017 also address the withholding income tax levied on the simultaneous execution of charter or lease agreements for vessels or rigs and service agreements. Charter/lease payments generally are not subject to withholding tax, as long as the percentages of charters/leases compared to the total payments due in charter/lease and service agreements do not exceed:

- 70 percent for vessels with floating production systems and/or storage and landing;
- 65 percent for vessels with drilling, completion or maintenance systems (drilling rigs); and
- 50 percent for other vessels.

The maximum percentages are applicable for new contracts and for existing contracts that are renegotiated or subject to a price adjustment.

If contracts do not follow the percentages set forth in legislation, the portion related to charters/leases exceeding the limit (e.g. 65 percent for drilling rigs) will be subject to a 15 percent withholding tax (25 percent where payment is made to a person in a tax haven or privileged tax jurisdictions.

These rules also apply to activities involving the transportation, handling, transfer, storage and regasification of liquefied natural gas.

## Conclusion

The changes to the income tax rules were enacted shortly before new bid rounds were concluded. With the increase in oil and gas projects in Brazil and the revised rules, companies are reevaluating business structures, such as the leasing of vessels, and updating the tax position of projects based on the amended deduction rules.

# UK: Transferable tax history

## Introduction

As the UK continental shelf enters its next phase of life, it is crucial that the companies that are best placed to operate assets in the most efficient way possible are given the opportunity to acquire them.

The UK Finance Act 2019, effective for transactions completing on or after 1 November 2018, introduced tax changes that allow the corporation tax history associated with an oil license to follow that license interest when it changes hands (in other words, sellers of oil licences can elect to transfer their tax history to the purchaser of the license). Prior to the introduction of this legislation, buyers had been able to deduct their decommissioning costs only against their own profits; in effect, the changes in the finance act enable purchasers to offset decommissioning costs from the profits made during the seller's ownership, thus allowing for a refund of taxes previously paid by the seller. This represents a significant departure from normal principles of UK taxation and blurs traditional lines between asset and share deals.

The legislation could prove to be a significant tool for stimulating deal activity in the UK North Sea and help bridge value gaps, which have been exacerbated historically by differences in the tax profiles of buyers and sellers.

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## The problem

In recent years, the participants in the UK North Sea oil and gas industry have become more diverse, with new entrants looking to take on assets that have been held for many years by major companies with a broad tax base. In some instances, these new entrants have been reluctant to purchase assets where there has been uncertainty as to whether they will be able to access tax relief on their full decommissioning spend. This has been the case where the successor has been looking to take on a license which, when decommissioning is factored in, is cashflow negative (in exchange for some consideration), or where companies have factored in downside cases (i.e. lower oil prices) as part of their valuation. In both scenarios, the purchaser would have been able to offset decommissioning costs only against its own profits, stranding losses if costs exceed profits over their ownership period.

In these cases, tax relief on decommissioning often would have been available to the incumbent (had the license remained in its hands), as it would have a long history of taxable profits against which to carry back decommissioning losses. However, a new entrant may not have a UK tax-paying history, which has placed a tax-driven valuation gap between buyers and sellers. Consequently, newer companies or late-life specialists with the potential to innovate alternative approaches to management of late-life fields have not been able to acquire certain assets.

## The solution

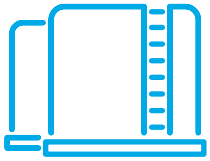
In early 2017, the Chancellor of the Exchequer appointed an industry-wide expert panel to consider the feasibility of potential solutions. One of the ideas identified—which also had been discussed at an industry-level—was to provide a mechanism for successor companies to "stand in the shoes" of the seller. This could be achieved by passing part of the seller's tax history to the buyer, i.e. the transferable tax history (TTH) upon completion of the sale.

The UK government accepted this idea and through late 2017 and 2018 worked on how to bring it into effect.

### Key design elements

The key features of the TTH are as follows:

- The seller and buyer make a joint election to notionally transfer an amount of the seller's historical taxable profits to the buyer. The buyer is permitted to carry back its losses against this transferred history in certain circumstances and the seller is treated as if it had never made (or paid) tax on those profits.
- The transfer of tax history is optional (such that the measure should not interfere with transactions that would have occurred in absence of these legislative changes).
- Safeguards exist to ensure that the amount transferred from the seller to the buyer is not excessive, including a cap at 200 percent of the buyer's estimated share of the decommissioning cost of the asset purchased per the asset's decommissioning security agreement;
- Approval for the TTH transferred can be issued by the UK tax authorities (HMRC), or the amount can be deemed to be approved if HMRC does not enquire into it by the end of the normal enquiry window for the transferor and transferee for the period in which the transfer occurs (if HMRC does not provide explicit approval, it will be some time before a high degree of comfort can be taken regarding the amount transferred).
- The tax history transferred becomes available to the purchaser when it is "activated" so that companies cannot exploit the legislation by accessing tax history that would not otherwise have given rise to refunds of tax. This activation requires the buyer to track the profits and losses generated by that asset in a "shadow" calculation included in the buyer's tax return. The TTH becomes activated once that asset has permanently ceased production and is loss-making on a cumulative basis (including decommissioning costs incurred) in the hands of the buyer.
- Buying companies must designate a "Senior Tracking Officer" to certify to HMRC that they have taken reasonable steps to ensure that the tracked profit and loss amount attributable to a TTH license for each tracking period is appropriate. Penalties apply for failure to comply.
- Activated TTH will be treated as part of the buyer's tax history and will be available for use against any decommissioning loss within that company (regardless of whether that decommissioning loss is a result of expenditure incurred on decommissioning the transferred asset or any other field).
- If the license interest is transferred again, the TTH will pass to the new purchasing entity. The shadow calculation passes with the TTH and both the new transferee and the original transferee's tracked profits must be fully offset by losses on the relevant field to activate the allowance.



- Although profit tracking will be disclosed to HMRC in each tax return of the transferee, HMRC will not initiate its review of these figures until the TTH is actually being utilized by the transferee. This could introduce an element of uncertainty over the numbers and HMRC's view of the legislation, particularly where a company inherits the profit tracking history of a predecessor.
- TTH typically is available only for transactions between unconnected third parties. There are provisions to permit TTH within a corporate group in certain circumstances, but only where there has been or will be a transaction to transfer that licence (or the company holding it) to a third party.

### Deloitte UK's view

In principle, the new rules should facilitate transactions where access to decommissioning tax relief has been a blocker, thus encouraging new entrants and the development of alternative business models for mid and late-life assets. In practice, it will be interesting to see whether the efficacy of the measure suffers from some of the complexity of legislation; although the principle is clear, the legislation is not straightforward.

Businesses will not likely welcome any factors creating uncertainty, which could result in significant discounting of the value of TTH to the buyer. The length of time it may take companies to have their TTH election approved by HMRC, coupled with the risk that HMRC may disagree with the tracking of profits (but do not raise this for several years) are examples of such factors. In addition, the possibility of HMRC taking action against individuals through the Senior Tracking Officer provisions may influence decision-makers to take a conservative approach. Although the Senior Accounting Officer requirements are a fact of business for qualifying companies, these companies may prevent the Senior Tracking Office rules from applying by not electing into the TTH rules.

### Conclusion

The innovative nature of the changes requires careful drafting with robust safeguards in place to protect all stakeholders. Despite any uncertainty companies may perceive within the TTH rules, they do represent a further tool when it comes to approaching M&A transactions involving the North Sea. If even one deal completes as a result of the new legislation, then the UK government will have achieved a further step towards its stated objective to maximize economic recovery in the North Sea. Once again, these changes appear to demonstrate the continuing commitment by the government to understand and address fiscal issues in the basin.

# Albania: Overview of the current fiscal environment

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## Introduction

The exploration and production of hydrocarbons in Albania commenced in the early 20th century, when a number of foreign companies entered into concession agreements with the Albanian government for the exploration and exploitation of onshore and offshore oil-bearing fields. In 1946, with the introduction of the communist regime in Albania, all industries, including oil and gas, became state owned. However, exploration and development continued, achieving the highest production peak in 1974, with an annual production equivalent to 38,408 barrels per day.

After the end of the communist regime in 1992, the new government introduced industry-specific legislation, namely, the Petroleum Law in 1993 and the Petroleum Fiscal Law in 1994. The National Agency of Natural Resources (NANR) is the government-appointed regulator for the deployment of natural resources in the mining, petroleum and energy sectors. NANR negotiates petroleum agreements and supervises their implementation through regular technical and financial audits. Albpetrol is the state-owned oil company that administers all operating oilfields in Albania, and some exploration blocks. Albpetrol is entitled to sub-grant the exploration and production rights on the oilfields under its administration to oil and gas companies through petroleum agreements, in which case it obtains a share of the oil and gas produced.

The main form of these agreements is the Production Sharing Agreement (PSA). Many multinational companies have entered into PSAs with the Albanian government for the exploration and production of oil and gas onshore and offshore since 1992. The most important current agreements are the PSA for the investment in, and operation of, the Patos-Marinza oilfield—considered the largest onshore oilfield in continental Europe—extracting around 90 percent[1] of total crude oil production in Albania, and the PSAs for the exploration activities in onshore Blocks 2-3 and Block 4.

Albania stands among 51 countries adhering to the Extractive Industry Transparency Initiative (EITI), a global initiative that seeks to improve the governance of the extractives sector.

Crude oil produced in Albania is mostly exported to be refined abroad. Overall in 2016, for example, exports of crude oil contributed to around 8 percent of Albania's exports.

Albania currently has little natural gas production (and production mostly serves the oil industry).

## Petroleum Law

The Petroleum Law expressly recognizes the Albanian state as the sole owner of all petroleum deposits existing in their natural condition in strata laying within the jurisdiction of Albania, and permits the Ministry of Energy to enter into a PSA (or other form of agreement) granting an oil company exclusive rights to explore and produce oil and gas for a limited period.

Under a PSA, the contractor assumes the financial and technical risk of operating the petroleum project in exchange for recovering its costs under the PSA from revenues from the sale of oil produced from the contract area. The Albanian state's interests in PSAs are administered by Albpetrol and AKBN, which derive from PSAs (as the case may be): bonuses, their share of oil, their share of profit petroleum, as well as revenue arising from contract breach and termination, such as penalties, executed guarantees, etc.

PSAs for oilfields discovered are granted for an initial production period no longer than 25 years and can be extended for up to another five years. Exploration activities are limited to five years but may be further extended if approved by the Ministry of Energy.

The Petroleum Law guarantees oil companies operating under petroleum agreements the right to export their share of production derived from operations in Albania (unless there is an emergency call on the supply of crude oil in the local market) and to freely withdraw the revenue earned out of Albania. Foreign investors may negotiate fiscal stability terms to mitigate the negative effect of future changes in the applicable tax legislation, although the implementation period of the stability terms has been limited to 12 years from the date production commences.

## Petroleum fiscal regime

The Petroleum Fiscal Law of 1994 is a short and outdated law that is due to be reformed to ensure legal clarity and consistency for current and potential investors. New industry-specific legislation has been prepared by the Ministry of Finance and Economy, with the assistance of the International Monetary Fund and is being discussed among stakeholders. The law is expected to be finalized and enter into force in 2020. This article describes the current petroleum fiscal regime (changes brought about by the proposed law will be addressed in future issues of this publication).

### Petroleum profit tax

Under the Petroleum Fiscal Law, petroleum contractors calculate the petroleum taxable profits by recognizing as recoverable costs all capital, operating and administrative expenditure and by recovering such costs from the revenues earned: (a) in accordance with the relevant PSAs, (b) based on criteria agreed by the minister, and (c) in line with international best practices.

The term "recoverable costs" is specific to the industry and means the costs incurred by the contractor during the exploration, development and production phase that will be recovered/covered by revenue from the sale of oil mostly in the production phase. The petroleum costs incurred in a year, which are audited and approved by NANR, are included in a "pool of recoverable costs" that is carried forward indefinitely over the PSA period. Depending on the PSA, a share of the oil production ("available petroleum") may be allocated to Albpetrol (in kind or in cash). Revenue from the sale of oil after deducting Albpetrol's share and the royalty tax (see below) gradually will cover/recover the costs by reducing the pool of recoverable costs until it becomes zero. After that time, any excess revenue will constitute profit petroleum. A share of the profit petroleum generally is allocated to NANR, and the remaining share belonging to contractors constitutes the taxable profit subject to the industry-specific tax rate of 50 percent.

However, the lack of a separate declaration form for petroleum profit tax results in some difficulties in presenting industry-specific items.

### Royalty tax

Royalty tax currently represents the principal revenue stream paid from the oil and gas sector to the state budget. Royalty tax is calculated at 10 percent of the sales value of the extracted crude oil. For domestic sales, the royalty tax is self-assessed and self-declared by the contractors and is subject to audit and eventual re-assessment by the tax authorities. For exports of crude oil, royalty tax applicable is assessed and collected by the customs authorities up-front and is paid by the contractors as a prerequisite to complete the customs export procedures.

### Value added tax (VAT)

Albania's VAT law is significantly harmonized with the EU VAT directive, with a view to the country attaining EU membership.

VAT on domestic sales of crude oil and gas is 20 percent and VAT on exports is zero percent.

An exhaustive list of eligible supplies of goods and services purchased/imported by contractors during the exploration phase may be exempt from VAT if the contractor follows certain procedures and obtains written approval from NANR.

### Social and health insurance contributions

A law introduced in 2017 addressing petroleum employees results in additional insurance costs for contractors and a number of benefits for current and former employees that have the status of petroleum/gas employees.

An additional social security contribution amounting to 5 percent of gross salary must be paid for employees in the petroleum and gas industry (3 percent payable by the employer, 2 percent by the employee). The salary of petroleum/gas employees should not be less than 150 percent of the minimum salary applicable in Albania.[2] Among other benefits, persons with the status of petroleum/gas employees that are or become unemployed in certain cases benefit from a certain amount of financial remuneration for a certain period. The beneficiaries of the status of petroleum/gas employees undergo free medical examinations twice a year and receive medical treatment free of charge (for diseases that are confirmed as being caused directly or indirectly from their work in the petroleum and gas industry).

### Personal income tax on employment income

Monthly personal income earned from employment up to ALL 30,000 (approximately USD 258) is exempt, income exceeding ALL 30,000 and up to ALL 130,000 (approximately USD 1,123)[3] is taxed at 13 percent and income exceeding this threshold is taxed at 23 percent. Tax is withheld at source by the employer.

Many PSAs provide that expatriate personnel of contractors will be exempt from Albanian taxes, but this exemption is not enforced under the Petroleum Fiscal Law or other tax laws and is not applicable in practice (see below).

### Excise tax, carbon tax and circulation tax

Excise tax,[4] carbon tax[5] and circulation tax[6] are imposed on imports or domestic production of several materials used by contractors as combustible materials in petroleum operations.

## Other tax aspects

There are certain other tax aspects that potential investors need to consider. For example, a PSA may provide for an exemption of the contractor from national and local taxes, duties, excise taxes etc., but these exemptions may not be properly enforced by tax laws and, therefore, may not be applicable in practice. Potential investors should consider obtaining local tax and legal advice before and during their negotiations for a PSA with the Albanian government, to possibly secure these tax advantages.

## A look into the future

The proposed petroleum fiscal legislation is expected to address most of the tax challenges faced by the industry in recent years such as:

- The hierarchy of audit rights over petroleum profit tax between NANR and the tax administration;
- Clarification of certain fiscal aspects applicable to Joint Operation Agreements;
- Ring fencing; and
- Introduction of a specific declaration form for petroleum profit tax, etc.

Looking ahead, the Trans-Adriatic Pipeline (TAP), scheduled to commence operations in 2020, is expected to play a major role in developing Albania's energy market and facilitating the country's objective of becoming a gas hub in the Western Balkans. Being one of the largest foreign direct investments in Albania to date, the TAP will be about 215 km onshore and 37 km offshore in the Albanian section of the Adriatic Sea. The Albanian government has approved the National Gas Master Plan, paving the way for important private investments for the construction of gas infrastructure.

In summary, Albania offers opportunities for investment by multinational oil and gas companies. It has a long record of oil production, operations and available oil and gas exploration blocks, expertise built through decades by Albanian petroleum employees and subcontractors, improved infrastructure, and an expected fiscal regime for oil and gas.

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# End Notes

1. According to the Extractive Industries Transparency Initiative in Albania, Report for 2016, published in February 2018: https://eiti.org/sites/default/files/documents/2016_albania_eiti_report.pdf
2. Currently at ALL 24,000 (approximately EUR 190).
3. It may be increased to ALL 150,000 (approximately EUR 1,155), starting from 1 January 2019.
4. A fixed level per unit, from ALL 0 to 200 per liter of energetic products.
5. A fixed level per unit e.g. ALL 1.5 per liter on gasoline, ALL 3 per liter on diesel, ALL 3 per liter on solar, etc.
6. A fixed level per unit e.g. ALL 27 per liter on gasoline, ALL 27 per liter on gasoil (diesel), etc.

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