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In this issue

Global oil & gas tax newsletter

Views from around the world

April 2017

Editor's introduction

Bill Page, Deloitte UK and Chris Roberge, Global oil & gas tax leader

Welcome to the first edition of the Global oil & gas tax newsletter for 2017, and what an exciting start it is! Many had hoped for increased predictability and stability in 2017 but this has yet to materialize and seems elusively floating on the horizon.

In this edition we explore a range of topics that can materially transform the industry and how tax practitioners operate within it. For starters, we explore the potential applications of Blockchain. Blockchain is a new digital technology that could have significant implications for the oil and gas industry. Both producers and governments alike could see fundamental shifts in the way tax is administered and controlled.

We also include an article explaining the basics of production sharing agreements. This is the first in a series of articles that will address topics and issues encountered by oil and gas tax practitioners. These articles are intended to provide an overview for readers looking for an introduction to the topic, or as a refresher for practitioners who do not encounter the subject matter regularly.

In 2016, we included a number of articles on the implications of the G20/OECD base erosion and profit shifting (BEPS) initiative. In this edition, we consider the multilateral instrument (MLI) that is being introduced to modify bilateral tax treaties in response to BEPS action 15. The MLI could affect the provisions of around 2,000 treaties currently in force, which equates to approximately two-thirds of the total number of treaties worldwide. On the same BEPS theme, we offer an analysis of some Dutch tax changes that illustrate how individual countries are responding to the BEPS agenda. In particular, changes to the very popular cooperative regime.

Building on an article published in the September 2016 edition on the introduction of value added tax (VAT) by the Gulf Cooperation Council, we look at further developments, even though this has progressed slower than expected.

Finally, we unpack the potential U.S. tax reforms that are expected to be presented by the Trump administration in the coming months. At the time of writing (mid-March), we still are awaiting a degree of detail on the potential reform and, therefore, we will provide readers with greater analysis in subsequent editions.

We trust you will enjoy reading this worldly edition of the most important tax changes that are impacting our industry. As ever, if you have any questions or comments on the contents of this newsletter, or suggestions for future articles, please do not hesitate to contact me atbpage@deloitte.co.uk or our global leader, Chris Roberge at chrisroberge@deloitte.com.

Blockchain: Overview of the potential applications for the oil and gas market and the related taxation implications

Geoffrey Cann, Deloitte Canada and Emily Catmur, Deloitte UK

Blockchain is sometimes likened to the internet in terms of its potential impact on the world. The cryptocurrency bitcoin, launched publically in 2009, is the most well-known use of blockchain, but this is just one of many potential applications. The potential uses for blockchain are growing, some of which could have significant implications for the oil and gas industry. This article offers a high-level summary of how blockchain works, its advantages over traditional systems, some of its potential applications, and how these can be applied to the oil and gas market, with a particular focus on taxation and compliance.

What is blockchain?

A blockchain is a "single source of truth" for shared information, such as financial transaction data (e.g., a quantity of bitcoins), legal contracts, deeds of ownership, and identity documentation. The information is recorded on a ledger that is distributed across every node (i.e., computer) in a network on the internet, and is structured and encrypted in such a way that it cannot be altered without agreement by a majority of the nodes in a network (which automatically and simultaneously check the change against the ledger). Any change, such as a payment from person A's bitcoin wallet to person B's bitcoin wallet, must be requested by the owner of the data (person A in this case), using a combination of private and public keys that validate the identity and legality of the transaction. The greater the number of nodes in a network, the more secure it is, since any attempt at fraud would require the corruption of the same chain in every node in a network simultaneously during the few seconds that the blockchain is processing a change. This process directly addresses the underlying issue of trust in society and business that creates the need for third-party validation (e.g., by banks or lawyers), since the network itself validates the change. When new information is added into the blockchain, a new block is created that is linked to the previous block (containing a related transaction or contract) and, therefore, the historic data remains in the chain and an audit trail exists.

As an example, in a relatively simple transaction such as buying a house, the seller currently would instruct lawyers to draw up the paperwork, terms are agreed upon, contracts are physically signed by both parties, proof of payment is provided, and the lawyers then arrange for the transfer of the title deed. Using blockchain, the seller could send the buyer the contract containing the digital certificate of ownership for the house in the blockchain. Once the buyer completes the terms of the contract by sending the payment, the contract is automatically completed and the digital certificate of ownership is transferred to the buyer. The nodes in the blockchain validate the transaction and simultaneously update the ledger. In this way, the updated ownership can be verified on any node. The transaction is completed quickly, without the need for third-party verification of signatures and payment, and the history of ownership remains in one secure and indisputable place—the blockchain.

Advantages of blockchain

Some of the main potential advantages of blockchain are the following:

- Cost and time savings;
- Increased transparency for individuals, companies, and authorities; and
- Mitigated risk of fraud and disputes.

Cost and time savings and increased transparency

In complex transactions for purchases of goods, for example, buyers issue purchase orders, shippers issue packing lists, sellers submit invoices, and banks release funds, all of which are wrapped up in agreements, contract terms, and numbering schemes that enforce tracking, delivery, and payment. The use of a blockchain for these activities would dramatically accelerate the process by cutting out the intermediaries that currently are needed to validate documents and release products and funds. It would create a clear audit trail of time-stamped documentation blocks that could be accessible to taxation and other authorities in real time, increasing transparency, and reducing the administrative burden on the parties involved.

Mitigated risk of fraud and disputes

Companies incur significant overheads assuring trust with counterparties and reducing the costs of eventual misunderstandings, disputes, and fraud. This includes writing and tracking all the contracts, compliance, reporting and monitoring, internally and in respect of service providers, along with all the associated paperwork. If the paperwork and the identity of participants, locations, asset type, and value were referenced and added to the blockchain, any dispute that arise could be dealt with by participants simply referencing this single ledger, rather than having to reconcile disparate databases and contracts.

Leading use cases of blockchain and potential applications for oil and gas companies

The oil and gas industry presents a particularly compelling opportunity to leverage blockchain technologies due to the high transactional values (and therefore risks) and economic pressures to reduce costs. A secure system that mitigates risk , increases transparency, provides an audit trail, and speeds up transactions at a significantly reduced cost may be appealing to oil and gas companies.

Taking some of the main applications of blockchain, we will now explore how these could be applied to the oil and gas sector.

Cross-border payments

One of the advantages of cryptocurrencies, such as bitcoin, is the significantly lower costs associated with cross-border payments, in addition to the instant transfer, cutting out the need for intermediaries and the time required for them to validate and clear the funds.

Oil and gas is sold in large volumes and as such entail significant value, not unlike the size and scale of transactions between banks. The frequency of transactions is also high; for example, a 300,000 barrel per day oil refinery will need to source a large crude carrier every week to maintain adequate volumes, and cargos can cost as much as USD 100 million (two million barrels at USD 50 per barrel). Oil companies also need to be aware of where crude is ultimately sourced. Some exporting nations are from time-to-time under sanctions to prevent trade in this commodity. Blockchain could provide a fully transparent and secure record of the entire supply chain.

Using a distributed ledger, digital tokens can be used to represent the asset being transacted. These tokens can be issued by a trusted authority for the needs of the companies or participating parties; for example, if oil and gas companies used a blockchain ledger to buy and sell barrels of oil, transactions could include digital tokens named Brent or WTI. These tokens would represent the underlying asset of a barrel of oil and would remain digitally attached throughout its supply chain journey. Currently, around nine percent of crude oil transactions are disputed, which equates to around USD 150 billion each year. By using tokens in a blockchain, payment could be processed more quickly, paperwork such as title transfers would be eliminated, and disputed transactions could be significantly reduced.

It is important to note that the token being exchanged will be subject to gains or losses based on the strength of the underlying fiat (local) currency. If 50 WTI tokens are purchased using US dollars, the value of these tokens are exposed to fluctuations in the US dollar.

As the use of cryptocurrencies increases, governments are forming positions on the taxation implications of cryptocurrencies and their exchange for fiat currency.

Blockchain is already being used for gold trading, with companies and mints offering customers digital gold tokens to be used in place of the gold, which remains safely in their vaults. While gold trading is straightforward as compared to oil and gas, this initial step may be a catalyst for other industries, and the basic structure will be ready to duplicate and customize. As with many technological advancements, it takes time for people to become accustomed to the technology and adopt it, and the use of blockchain for cross-border payments is increasing rapidly as it becomes a more accepted transaction method.

Blockchain taxation legislation has yet to be drawn up by governments and is needed to determine, for example, when and where transactions will be deemed to have taken place for direct and indirect taxation purposes. If companies are required to include identification data in the blockchain, this could be easily addressed because their ownership structures, including beneficial ownership, would become more transparent. For example, the blockchain could evidence what is being supplied and to whom (e.g., a business customer or a consumer), which would determine in which location the transaction is subject to indirect taxes.

Indirect taxation, in general, could benefit greatly from the clarity that blockchain provides, but the taxation implications will be situation-specific and legislation will need to address this. Clear guidance will be needed to determine whether a cryptocurrency would be used in the same way as money (e.g., bitcoin) and, therefore, likely would fall outside the scope of a VAT system; or whether any restrictions relating to the redemption of the cryptocurrency would deem it to be a barter transaction or similar to a loyalty points system, both of which incur different indirect taxation treatment in most VAT systems.

Record management

In the above example relating to the sale of a house, the digital certificate of ownership is transferred to the buyer in the blockchain and a historic chain of ownership exists indefinitely. Property transactions provide an excellent example of how the use of blockchain can help business keep accurate and readily accessible records.

Oil and gas companies need to acquire rights to access land to prospect for, explore, appraise, and then produce oil and gas. Understanding land provenance and reported value can be difficult and multiple records of conflicting ownership and value can exist within independent silos of data. There is often no accurate history of the transactions. In this mostly paper-based environment, land transactions are highly susceptible to fraud, especially in countries with higher levels of corruption.

Blockchain technology can be employed to resolve this problem and is being trialed in certain countries, such as Georgia and Ghana, which experience high levels of undocumented land ownership and land seizures. Applying the same model to the oil and gas industry by recording sales and transfers of land in a blockchain will create an immutable audit trail of land movement, value, and ownership. This will reduce the occurrence of lost or mismatching titles, ownership disputes, and provide tax authorities with transparency in respect of land transactions, recording accurate transfers of value as they occur in real time.

Supply chain management

Global supply chains in the oil and gas industry comprise a complex web of suppliers, shippers, and contractors. The complexity and scale of this network requires substantial administration and creates opportunities for errors. From the tax authorities' and customers' perspectives, there also is a concern that suppliers might manipulate invoice values, potentially avoiding taxes or inflating costs, as goods are sold and shipped around the world.

Utilizing blockchain technology to record and manage the movement of goods and related invoices will significantly mitigate the risk of errors and the opportunity to alter invoice values or recipients. Goods will be tracked from source to customer, reducing time and costs, and providing insight into the supply chain process that could be used to create efficiencies. Invoices will be recorded in the blockchain, creating an immutable record of its contents. The movement of invoices also can be addressed in the blockchain using public and private keys, preventing unapproved parties from accessing the invoices. This again could help to reduce the administrative burden on companies to report transactions to authorities and reduce the time taken by tax authority audits because of the reliability and transparency of data in the blockchain.

The issue of security in data transfer is important to

both individuals and companies. Public and private keys allow data to be encrypted and sent to another party, so that only that party can access the encrypted data. In the case of an invoice, party A would encrypt the invoice using party B's public key. Party B can then decrypt the invoice using its own private key. Anyone in the network could see that party A has sent data to party B, but is unable to decrypt the contents. Additionally, party A can sign the invoice with its private key before sending, and any subsequent alteration of the invoice would invalidate the signature and the fraud would be apparent.

Smart contracts

Oil and gas contracting can be complex, with lengthy contracts and agreements. A contract is often adjusted by a change order that needs to be tracked, and in some cases, contracts may be agreed some years before they are due to be completed.

Smart contracts are self-executing contracts based on agreed criteria and written in code, removing the ambiguity of terms and reducing the requirement for lawyers to draft and interpret. When the criteria of the contract are fulfilled, ownership or payment, for example, will be automatically transferred. A smart contract could be amended if the parties agree, and would maintain a record of all versions and amendments to the contract. It then would automatically complete once the criteria of the most up to date version are satisfied. Criteria could include payment or even government approval for the transaction. This may save time and costs for interpreting legal terms and tracking records, and government authorities could potentially access relevant parts of contracts to audit or pre-approve the taxation treatment.

Joint ventures are common in the oil and gas industry and generally require a suite of complex agreements (for example, relating to the sharing of costs or revenues), which could be implemented as smart contracts. Most contracts contain audit clauses giving the parties the right to audit each other to make sure that all parties are complying with the contract. Introducing a blockchain ledger to record joint venture transactions and using smart contracts to define, negotiate, and execute the contractual conditions will provide all involved parties, including the tax authorities, with transparency and consensus on what has occurred. This single audit trail, agreed upon by all participants, will significantly reduce the effort needed to ensure timely tax compliance and reporting, as well as the effort needed by the tax authorities to understand tax positions.

As part of a global industry, oil and gas companies have to consider double taxation and transfer pricing implications. The use of smart contracts for transfer pricing profit allocation is another area of potential for simplification, increased transparency, and overall cost reduction.

Emerging markets

One of the most significant challenges of emerging markets is their ability to hire, train, and develop regulatory officials. In particular, finding and developing the officials to oversee and administer taxation affairs is a key concern. The application of tax laws to different pieces of the value chain is extremely complex and an overbearing burden for many developing countries. The application of blockchain can alleviate this acute pain point for developing countries and provide confidence in the application and regulation of their resource regime.

Further considerations

The potential uses of blockchain are wide and varied, and the technology is becoming more prevalent. In the oil and gas industry, like many others, companies may face the choice of deciding whether to pioneer new technologies and in the process disrupt their own business model and industry, or to continue to focus on their core business and wait for the market to be disrupted by others. The pace at which blockchain will be adopted and will disrupt markets is unclear, and may be decided, to some extent, by the largest companies that will need to work together to drive innovation and solutions due to the global and collaborative nature of blockchain. Potential considerations for oil and gas companies are to set up or join working groups to explore blockchain and its potential applications or to launch a trial with an existing trusted business partner to better understand blockchain and the value it could create.

Introduction to production sharing agreements

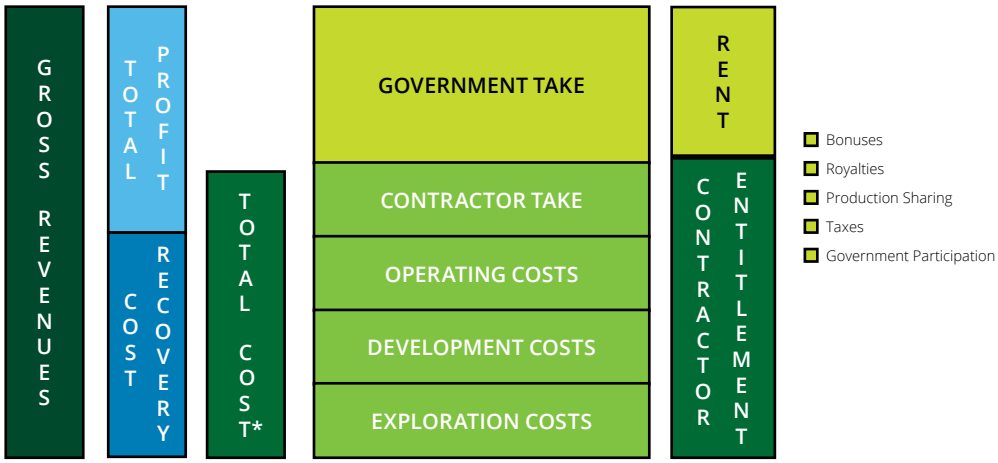
Bill Page, Deloitte UK

Production sharing agreements (PSAs), also often referred to as production sharing contracts (PSCs), are commonly used in the upstream oil and gas industry, particularly (but not exclusively) in developing countries. The fundamental concept underpinning PSAs is that the state owns hydrocarbons beneath the land or seabed. To exploit these resources, the government, on behalf of the state, enters into a PSA with an oil and gas company (usually called the "contractor"), which undertakes to explore and (if successful) exploit hydrocarbons at its own risk and expense. In return, if the project is successful, the contractor is entitled to share the hydrocarbons produced to recover its costs and receive profits to compensate it (sometimes referred to as the "contractor take"). In many projects, the contractor comprises a number of unrelated oil and gas companies working together under a joint operating agreement, one of which is designated as the "operator" of the project. The government sets out to recover the economic rent from the exploitation of hydrocarbons by sharing in the production itself and imposing various types of taxes on the contractor. In this context, economic rent may be defined as the return on the exploitation of natural resources in excess of the minimum level of profit the contractor would accept to undertake the project. The government share of hydrocarbons and the various types of taxes imposed, together, are sometimes referred to as the "government take." Some or all elements of the government take may be collected by the national oil company (NOC) rather than directly by the relevant ministry or the tax authorities on behalf of the government. Given the potential for significant economic rent from oil and gas projects, it is not usual for government take to exceed 75 percent of total profits.

Jurisdictions that have not adopted PSAs usually will license oil and gas companies to explore, develop, and produce under a concession agreement. These often impose royalties, along with regular taxation and an excess or additional profits tax (see discussion below) to capture economic rent. Though different in legal form, since the government does not directly receive a share of hydrocarbons produced, the economic effect of a concession may be very similar to a PSA, particularly if royalties are applied.

Key elements of government take

Various elements of revenue, profit, and cost under a typical PSA can be illustrated graphically:



* Total cost from the perspective of the government.

Fiscal terms for upstream projects under PSAs usually comprise several different mechanisms that the government applies to collect economic rent. The degree to which these terms are negotiable before entering into a PSA varies between jurisdictions (and tends to reduce over time as basins mature and exploration risk reduces). Guidance usually is provided in a publically available model PSA. In emerging economies, governments may wish to accelerate the collection of cash from the project, and there are a number of strategies available for this purpose. Two methods enable the collection of revenue from the commencement of a project:

Bonuses
Payment of a bonus to the government at the time a PSA is signed is a common method, and some countries have reportedly collected billions of US dollars on signing PSAs for particularly prospective areas as part of a competitive bidding involving multiple oil and gas companies. Signature bonuses are not universal, however, and if they apply, the amounts usually are more modest as the impact of large up-front bonuses on the present value of exploration projects can be sufficient to render them uneconomic.

In addition to signature bonuses, PSAs can include bonuses payable on the declaration of a commercial discovery, commencement of commercial production, or on achieving certain levels of daily production.

Rental payments
PSAs normally include an exclusive right to explore and eventually develop and produce hydrocarbons in a specific geographical area (usually referred to as a "block"). It is usual for the contractor to be required to pay the government a fixed amount by reference to the area of the block. The rate per unit of area normally will increase in the development and production phase of a project, although the contractor often will be required to surrender its rights over areas of the block not associated with field development.

Absent specific exemptions, projects will generate other forms of government revenue in this phase through taxation of employees and subcontractors, which frequently are taxed under the general tax rules.

Other elements of government take start to apply once a project begins to generate revenue:

Royalties
Royalties are found in most PSA regimes and normally apply as soon as production commences. The royalty may be expressed as a percentage of either the production itself or of the revenue derived from sales. Rates vary, but most fall in the range of five percent to 20 percent and may vary depending on whether hydrocarbons produced are gas or liquids, geographical location, maturity of the basin, etc. Rates may be fixed or on a sliding scale, where the rate of royalty increases as the volume produced increases or commodity prices change. There may be an option for the government to collect royalties in cash or in kind at its discretion.

Where royalty is applied to the value of production, rather than simply the volume, the basis of valuation is usually subject to transfer pricing rules set out in the PSA itself. This may require a net-back calculation if the royalty is applied to well-head value and hydrocarbon sales are made after some processing and transportation costs have been incurred.

Production sharing
The mechanism which allocates hydrocarbon production between the contractor and the government lies at the heart of a PSA. The contractor is first entitled to recover qualifying costs. The PSA will include an accounting procedure that will define in detail what costs qualify for cost recovery. Usually these will include exploration, development and operating costs and reserves set aside as provided in the PSA to cover future decommissioning costs (as these will be incurred in periods when there will be little or no revenue out of which to recover the costs). The most common exclusions from recoverable costs are interest and related costs in respect of loans used to finance operations under the PSA, and head office allocation costs, and any costs related to activities not linked to operations under the specific PSA, which will include transport, processing and marketing beyond a defined 'delivery point' and costs related to projects under different PSAs. After an allocation of production to be shared between the parties, even at the start of production. The effect of such a cap is economically similar to a royalty, so some jurisdictions that apply a cost recovery cap have not included royalties in their PSAs. Any recoverable costs not recovered in a particular period may be carried forward for recovery in later periods until fully utilized. Capital expenditure may be subject to recovery over a number of years via a depreciation charge, rather than as incurred. It also is worth noting that most PSAs provide for ownership of any fixed assets to pass to the government at some point at no cost, for example, once the relevant cost has been recovered, or at the expiry of the term of the PSA.

Some Indonesian PSAs include a formula that shares gross production before cost recovery (referred to as "first tranche petroleum"), with a subsequent allocation of profit oil/gas. The economic effect of this is similar to royalty or a cost recovery cap.

The formula for sharing profit oil or gas between the contractor and the government may be quite simple, with the government share fixed or increasing as the volume of production increases. However, approaches that are more complex also are common, particularly in more recent PSAs, for example, linking the allocation to the contractor's internal rate of return (IRR) with the government share, rising as the IRR of the project increases. Another approach is the use of an "R" factor that links the parties' share of profit oil/gas to the ratio of cumulative revenues to cumulative costs; the higher the revenues in relation to costs, the higher the share allocated to the government. Both approaches can create difficulties in practice if the contractor comprises more than one entity each having a different IRR or R factor on a standalone basis.

Other forms of taxation normally will only apply once a project starts to generate profits.

Corporate income tax (CIT)

Most jurisdictions apply CIT to upstream operations, although the specifics of the industry may mean that the applicable rules differ in significant respects from the rules applying to other types of activity. The mechanics of the CIT calculation often will operate independently of the production sharing mechanism so that the starting point will be financial statements showing revenues arising from sales of the contractor's cost recovery and profit oil/gas and with adjustments based on general tax rules, such as the disallowance of book depreciation and the deduction of tax depreciation. In some jurisdictions, the rules for calculating CIT may be set out in the PSA itself, or the PSA may simply refer to the relevant CIT law. In other jurisdictions, the base for CIT may be more closely linked to the production sharing formula, with CIT applied to the contractor's share of profit oil/gas, without any adjustment.

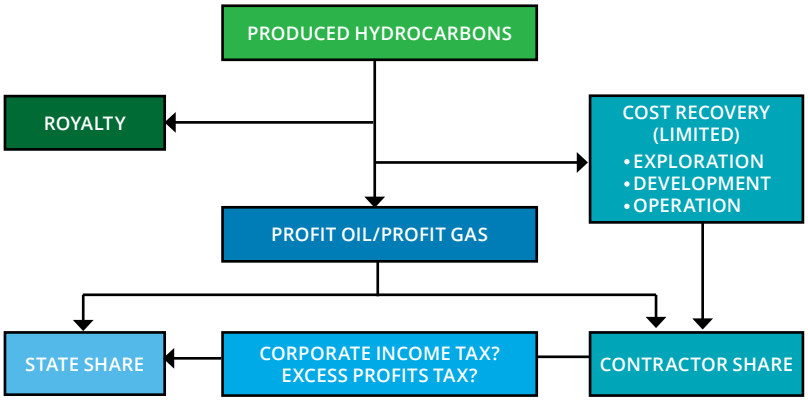
The PSA or the law frequently will stipulate that CIT should be calculated separately for each PSA held by a particular company, or even separately for individual developments within a PSA block. This is referred to as "ring-fencing."

A further complexity is the principle of deeming CIT to be part of the government share of profit oil/gas, which is found in many PSA regimes. This provides the contractor with some protection against disadvantageous changes in the CIT, such a rate increase or restrictions on the period that losses may be carried forward. It also requires the inclusion of a formula to gross-up the contractor's profit oil/gas share to determine the amount of CIT effectively paid, as well as an administrative mechanism to enable the contractor to demonstrate to the tax authorities that CIT actually has been paid, even though the government share of profit oil/gas has been passed to the NOC or relevant ministry. This administrative mechanism is also important if the contractor needs to demonstrate the CIT payments for the purposes of claiming a foreign tax credit in its home jurisdiction.

Excess or additional profits tax

Some tax regimes for hydrocarbon extraction include an excess or additional profits tax to capture economic rent, and the base may be linked to an R factor formula or the IRR of a project. These types of taxes are more common under concession regimes than under PSA regimes, but may be encountered in a PSA that shares profit oil/gas in accordance with a fixed share or volume-based scale, rather than using profit-linked metrics (such as IRR or the R factor).

Typical Production Sharing Mechanism



Other taxes

Oil and gas companies participating in a PSA usually are required to act as the withholding agent for taxes imposed on employees and subcontractors/suppliers, and these obligations start with the commencement of activities, creating tax revenues even if there is no commercial discovery. Occasionally, a PSA may provide exemptions or specific rules, but it is more normal for general tax law to apply. The taxation of subcontractors and other suppliers itself can give rise to complex issues, although these are beyond the scope of this article. A contractor also may be subject to additional payroll taxes and social security levies. Other taxes that may be applicable include transaction taxes and stamp duties. An exemption from import taxes, such as customs duties and VAT, often may be available, though sometimes the relief is available only for a limited period, rather than the life of the project.

VAT creates complex issues for the oil and gas industry, because of the heavy up-front costs which may be subject to VAT, and the fact that many upstream projects make export sales which are zero rated. Moreover, many countries do not pay out indirect tax credits but rather hold these as credits against future taxes. These will be the subject of a separate article (to be published later in 2017).

Other forms of government take

PSAs often contain other obligations that contribute to the overall government take, whilst not being explicitly fiscal in nature. These may include the following:

- *Carried interest:* The NOC or the government may elect to take an equity stake in the PSA. The right usually must be exercised before the commencement of development of a discovery, but without an obligation to reimburse any share of prior costs. The NOC's or government's proportionate share of development costs is often to be paid by the contractor and may be recovered out of the NOC's or government's equity share of profit oil, sometimes with an uplift to reflect the time value of money.

- *Social expenditure obligations:* The contractor may be obliged to pay for infrastructure such as roads, harbors, hospitals, and schools, which may indirectly benefit the project, but are more usually seen as government responsibilities. Such expenditure may not be cost recoverable or deductible in computing CIT and it may be that associated VAT will not be treated as a creditable input tax.

- *Domestic market obligation (DMO):* This refers to an obligation to sell production to the government or the NOC to meet local demand. PSAs usually contain a formula setting out how the price for DMO is to be determined. If the price to be paid is lower than that obtainable in the preferred market, the effect can be economically similar to an additional layer of taxation.

Transfer pricing

Transfer pricing is a key issue from a revenue and a cost perspective as it affects the calculation of the various elements of government take. PSAs usually will contain detailed rules for valuing non-arm's length sales and hydrocarbons on hand, although these may not address more complex issues, such as hedging. There also usually will be a requirement for all related party charges to reflect arm's length amounts. Under some PSAs, cost recovery for the contractor's overhead may be fixed as a percentage of total expenditure, rather linked to actual amounts expended.

Acquisitions and disposals

Transfers of interests in PSAs is a matter of great interest to the government and most PSAs will require government consent prior to a transfer in cases of direct and even indirect sales (e.g., via a sale of shares in a contractor). Though such transfers do not create additional economic rent, governments may seek to impose tax and the consent requirement will give them a significant lever to apply tax even where the application of tax legislation may not be completely clear.

From the perspective of production sharing, the usual approach is for the transferee to step into the transferor's shoes, inheriting any pools of unrecovered costs, and usually there is no direct impact on the profit oil/gas sharing formula.

From a CIT perspective, the position usually is more complex with a variety of approaches as to what constitutes base costs and how (or whether) to incorporate the value of non-cash consideration, such as disproportionate cost sharing on a farm-in. Restrictions may be imposed on the acquirer's ability to take tax depreciation on the consideration; for example, the acquisition cost may be depreciated at a slower rate than the original capital expenditure, or there may be no provision to allow a step-up in the tax basis for future

depreciation where the consideration exceeds the original cost of the PSA assets. There also is variation in the extent to which the CIT rules affecting transfers are covered in the PSA itself or in the general tax law. In recent years, many jurisdictions have extended their tax regimes to capture tax on gains arising on indirect disposals. There are two main approaches:

- Extending the definition of domestic-source income to include any gains on shares deriving their value wholly or in part from hydrocarbon resources situated within the jurisdiction; or
- On a change of control of a contractor, deeming a disposal and reacquisition of PSA interests in the jurisdiction at market value crystallizing taxable gains (or losses).

It also should be noted that such rules may not provide an exemption for stock market transactions or transfers within a corporate group and market values usually will be substituted for actual consideration in cases of non-arm's length transfers.

Other taxes may arise on direct and indirect PSA transfers; for example, a direct transfer is likely to be a supply for VAT purposes, though many VAT regimes apply an exemption to transfers of a business (or part of a business) as a going concern, which may be available for PSA transfers. Stamp duty and other types of transaction tax also may be applicable, and can be material if calculated on an ad valorem basis.

Fiscal stability and interaction with general tax law

Emerging markets often offer fiscal stability for limited periods to encourage potential investors. Since a PSA contractor normally is subject to the general tax regime (in combination with any modification provided by the PSA itself), which may change from time to time and upstream projects generally last for decades, this is particularly attractive for oil and gas companies. As noted above, one of the methods often adopted for PSAs is to carve CIT out of the government's share of profit oil/gas, so that any increase in tax rate, or other changes increasing the CIT burden on the project, do not impact the cash position of the contractor. Another common approach in the past was to freeze the tax rules applicable to a PSA at its effective date so that no subsequent changes would apply to the contractor. This approach is no longer widely used; instead, an economic stabilization provision is often included, enabling the contractor and the government to renegotiate the terms of a PSA to maintain the balance of economic interests between the parties in the event of a law change that is disadvantageous to either. This usually applies to any change in law, not only a change in tax rules applying to the project. It is important to note that an economic stabilization clause does not provide an explicit basis to set aside any law change as far as the PSA is concerned, nor does it guarantee that the parties will agree whether or how the disadvantaged party will be compensated.

The question of stabilization raises a wider issue of how rules included in a PSA interact with general laws, specifically tax laws. In many jurisdictions, a PSA is subject to a process that gives it the status of a law (e.g., presidential signature, approval by the cabinet of ministers), so that its terms override any potentially conflicting legislation. This is not universal, however, and in some cases, a PSA will only create contractual rights so that its provisions may be overridden by tax and other laws. In case of a conflict, the contractor's redress usually would be under the dispute resolution mechanism set out in the PSA.

Other issues normally covered in PSAs

PSAs typically are lengthy documents and cover many issues apart from the fiscal and related issues discussed in this article. A typical PSA would include the following provisions:

- Term of the PSA, including the obligation to surrender parts of the relevant block at various points;
- Minimum obligations in terms of expenditure and work to be carried out on the block (e.g., kilometers of seismic to be shot, number of wells to be drilled);
- Accounting and record-keeping obligations;
- Government scrutiny and approval of project planning and budgets;
- Health, safety, security, and environmental matters;
- Government participation and ownership of assets;
- Decommissioning;
- Local employment, training, and local content obligations;
- Specific provisions for gas development;
- Joint development of deposits contained in more than one block;
- Application of foreign exchange controls;
- Guarantees in relation to rights to import and export;
- Force majeure; and
- Governing law and dispute resolution.

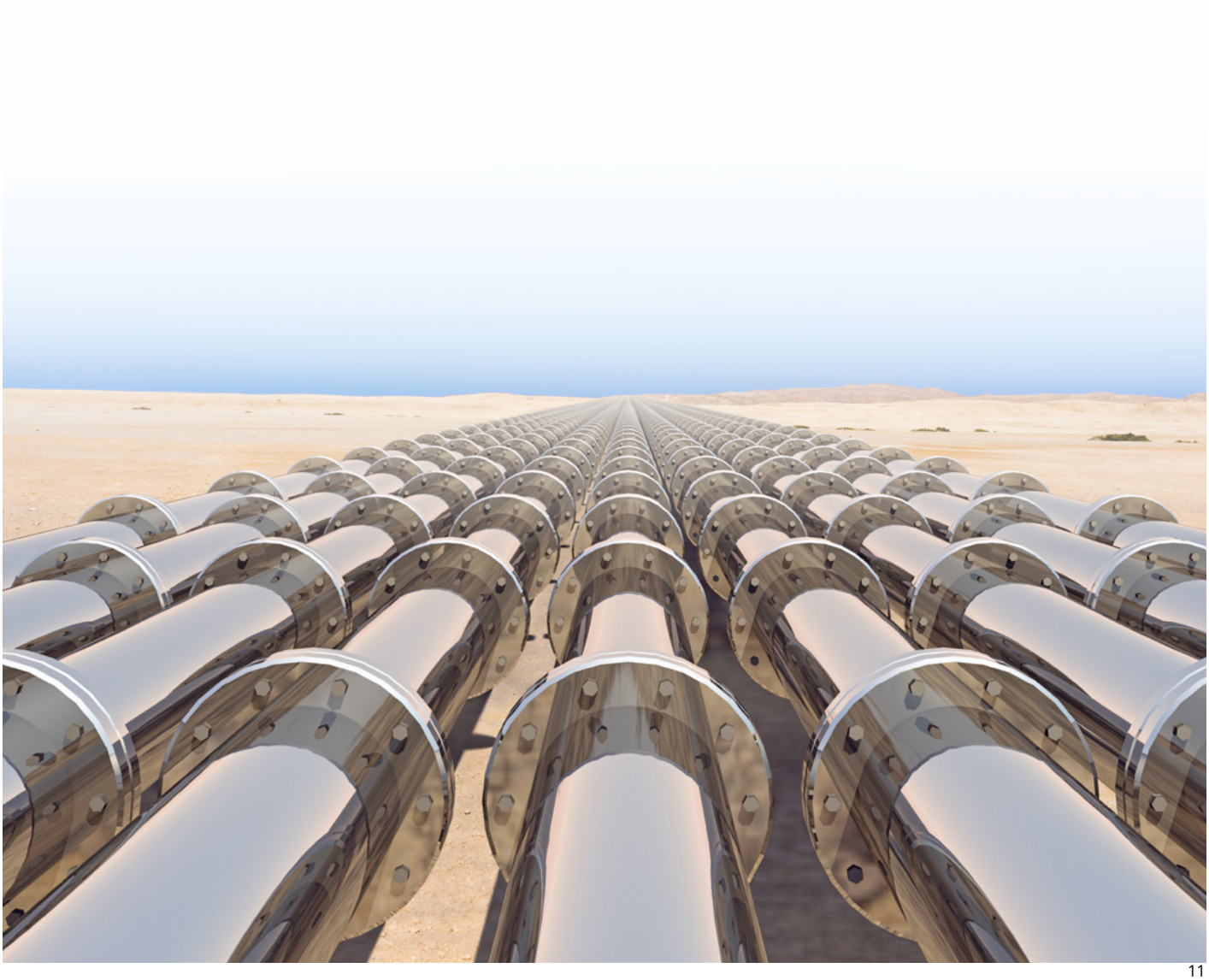
Practical issues

Implementation of PSAs raises numerous practical issues that are beyond the scope of this article, but which we will return to in future issues. For example:

- Reporting of production sharing and various tax payments for the purposes of country-by-country reporting requirements of BEPS and the Extractive Industries Transparency Initiative (EITI);
- Interaction with BEPS requirements, for example, in the area of transfer pricing; and
- Reporting of PSA activities under IFRS, including dealing with deferred tax implications (a particular issue for PSAs where CIT is part of the government share of profit oil/gas).

Tax advisers (whether in-house or external advisers) have a key role to play in the upstream oil and gas industry. In the negotiation process, bonuses and the profit oil or gas split often are open for discussion, but royalties and the application of CIT and other taxes normally are prescribed by legislation and/or the PSA itself. However, it still is important to understand how taxes will affect project economics in order to determine the parameters within which to set those items that may be negotiated.

The role of the tax adviser does not diminish after a PSA is signed. Accurate and timely tax compliance and reporting is critical even in the exploration phase, and a thorough understanding of the PSA and its interaction with general tax law becomes even more important in the event of acquisitions and disposals of interests, planning for development and, ultimately, decommissioning. It also is important to remember that many PSAs, particularly more recent ones, do not insulate the contractor from tax changes; these must be applied, although the economic stability clause could be invoked if a tax change disadvantages the contractor.



BEPS action 15: Implications of the multilateral instrument under the OECD BEPS project

Axelle Brière, Deloitte UK

As readers will recall, in October 2015, the OECD published the final reports on the 15-pronged action plan for countering base erosion and profit shifting or BEPS.

Some of the recommendations in the final reports require changes to double tax treaties. An ad hoc group was set up to work on an instrument that would provide participating countries with a simple mechanism to change multiple treaties, without the need for undertaking bilateral negotiations. One hundred and three jurisdictions participated in the ad hoc group; if all were to ratify the multilateral convention (sometimes referred to as the multilateral instrument or MLI), over 2,000 tax treaties would be modified.

The convention

The final text of the MLI was released on 24 November 2016, accompanied by an explanatory statement that provides a clarification of the approach taken and how each article of the MLI is intended to affect tax treaties covered by the convention. The MLI can apply to tax treaties based on both the UN and OECD model tax treaties.

The first signing ceremony for the MLI will be held in June 2017 in Paris, and it will enter into force once ratified by five jurisdictions. The first changes made by the MLI are likely to have effect from 1 January 2018, although 1 January 2019 may be a more realistic date for many countries.

The MLI will be open for signature by any jurisdiction, regardless of whether the jurisdiction was part of the ad hoc group that drafted the instrument. Countries signing the MLI must implement the minimum standards for tax treaties set out in the BEPS recommendations and they may choose to adopt optional changes.

The MLI covers the following BEPS actions:

- Action 2 – Hybrid mismatches – tax treaty changes only;
- Action 6 – Treaty abuse;
- Action 7 – Permanent establishment (PE); and
- Action 14 – Dispute resolution.

The MLI optionally permits participating countries to adopt mandatory binding arbitration as a means for resolving disputes. The work on this area was covered in a sub-group of 27 countries, as the work had not been undertaken when the original BEPS recommendations were released.

The MLI provides flexibility in that jurisdictions must specify the tax treaties to which the MLI applies ("Covered Tax Agreements"), thus permitting countries to exclude certain treaties.

The four actions include optional provisions and countries may elect whether or not to adopt them. The minimum standard treaty abuse provision also includes a choice. The mechanism for setting out a country's choices is in technical reservations, which must be filed on signing the MLI.

Jurisdictions will provide the OECD, as depositary, with a list of the double tax treaties to be covered by the MLI, along with any technical reservations. This information will be made available on the OECD website.

At this stage, three countries—Australia, New Zealand, and the U.K.—have set out in draft for comment their proposed technical reservations.

Two important points in terms of application of the MLI should be noted: a treaty will be modified only if both parties agree (through having matching, or compatible, technical reservations) and jurisdictions still will need to comply with their domestic constitutional approval process for the MLI. In France, for example, all new international treaties must be approved by parliament before they can be implemented, and in the U.K., there is a special procedure for treaty ratification by a committee of the House of Commons.

While all clauses are relevant for the energy sector, we will address two specific topics and their implications: the PE and the mandatory binding arbitration clauses.

Both provisions are optional (i.e., they do not form part of the minimum standard). It is unclear at this stage which countries will propose adopting the new treaty articles, although both the U.K. and the U.S. have indicated they will not accept the new PE article. Countries considering adopting the new PE definition may wish to gain a better understanding of the profit allocation methodology. The draft commentary on profit allocation was released for public comment in 2016, but it is not clear when it will be finalized.

Modified definition of PE

The complex nature of the oil and gas industry provides challenges for tax authorities. In particular, whilst hydrocarbon resources and tangible assets, such as refineries, are fixed, people and capital move easily, which creates uncertainty around the appropriate allocation of taxing rights.

BEPS action 7 is intended to help address this by lowering the threshold at which a PE is created in three ways:

- **Broadening the scope of dependent agent PEs**
  Under the updated concept of dependent agent, a PE exists where a person is acting on behalf of an enterprise and "habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." Moreover, the independent agent exemption will not be available to agents acting exclusively for a single group of companies. The changes to the scope of agency probably are more relevant for commodity trading activities or for oil field services companies than for upstream activities, where an agent would negotiate on behalf of a foreign group. In this framework, the mandate given to the agent will need to be carefully reviewed.

- **Narrowing exemptions for fixed place of business PEs**
  The final report on article 7 narrowed the exemptions available regarding preparatory or auxiliary in character exemptions and by introducing anti-fragmentation rules. For example, the storing of goods in a bonded warehouse during the customs clearance process would be considered preparatory and auxiliary.

  This new definition is likely to affect the storage of oil and gas. While storage is key in the supply chain from wellhead to customers for an upstream company, it may be regarded as an auxiliary function not creating a PE. On the other hand, storage by traders may be undertaken for speculative purposes and, hence, may be seen as a core part of their business, creating a taxable presence in a foreign country.

  Changes to the OECD model treaty and existing treaties will mean that exceptions to the creation of a fixed place of business for specific activities (such as the maintenance of stocks of goods for storage, display, delivery or processing, purchasing, or the collection of information) will apply only where the activity (or activities) in question is preparatory or auxiliary in relation to the business as a whole.

  These changes also aim to cover situations where several group companies (the same enterprise or closely related enterprises) split among themselves the complementary functions that are part of a cohesive business operation. Therefore, the anti-fragmentation rule is designed to limit the use of the preparatory or auxiliary activities exemption.

- **Countering avoidance of PE's where long duration construction contracts are split into a series of shorter contracts**
  This section addresses the splitting up of contracts between group companies to circumvent the specific 12-month period for creating a PE for building sites and construction or installation projects.

  The activities of related parties will be viewed in combination, rather than in isolation, when determining whether the activities are preparatory and auxiliary.

  Oil and gas projects usually imply a long-term presence in jurisdictions other than where a group's head office is located. Therefore, upstream operators and their suppliers are likely to be directly affected by the contemplated changes of wording allowed by the MLI.

The new PE definition is clearly targeted at a small number of scenarios, but has been criticized for creating additional uncertainty. There also is concern that many more taxable presences will be created without bringing additional profits to be taxed in those locations.

However, as mentioned above, the strength of the MLI (i.e., its flexibility) may have negative implications for some taxpayers. Since countries are able to choose which of the provisions they want to implement, if one country decides to amend its PE definition but another does not, their bilateral treaty will not be altered.

All companies working in the oil and gas sector should carefully review their structures to determine whether or not their activities in relevant jurisdictions could create PEs under the new definitions and if so, whether additional taxes would be due and whether the exposure could be mitigated with alternative commercial arrangements. New projects also should factor in the level of activity required, as well as the presence needed in each relevant location to understand the full tax exposure in country.

As noted above, some countries already have indicated which clauses of the MLI will be applied to their tax treaties. In December 2016, the UK indicated it intends to retain its existing domestic PE definition and related clause in tax treaties, but may be interested in the anti-fragmentation rule, and the U.S. has clearly stated that it will not amend the PE definition.

Binding arbitration

Upstream operators already are very familiar with binding arbitration as an alternative dispute resolution mechanism in the context of disputes arising with states where they operate; however, this mechanism is less known in the framework of international tax issues.

The traditional approach is through the local jurisdiction system and, if possible and needed, exchanges between states. As this could lead to protracted discussions, a sub-group chaired by Sweden comprising of 27 jurisdictions developed new optional provisions regarding mandatory binding arbitration.

As for the other clauses in the MLI, binding arbitration rules will apply only if both parties to a treaty opt in. However, parties are free to determine the scope of cases that will be eligible for arbitration (subject to acceptance by the other relevant parties). There is no limitation or guidance in the MLI about the possible reservations.

Generally, it is proposed that a taxpayer can request arbitration where a case has been subject to a mutual agreement procedure (MAP) for at least two years without resolution. Three arbitrators will be part of the arbitration panel and each competent authority of the concerned countries will nominate one arbitrator. The chair will be appointed from a third jurisdiction, by the other two arbitrators.

Two types of decision-making processes are permitted:

- Final offer rules, whereby each tax authority presents its own proposed resolution and the arbitrators choose their preferred outcome, which becomes binding on the parties; and
- The independent opinion approach, which results in a binding decision written by the arbitrators based on their analysis of the information provided to them.

If jurisdictions have mandated different default approaches, then arbitration cannot proceed until both authorities agree on an approach.

In both cases, the decision is final and there is no right of appeal for the unsuccessful party. The MAP currently requires two countries to make their best efforts to resolve a dispute where the taxpayer suffers double taxation. The only binding obligation on the states is to act in good faith and do all they can to agree. It is

inherently a zero sum game for the negotiating parties, so resolution can be hard to achieve. In practice, taxpayers are reluctant to initiate the MAP because of the uncertainty it creates and the time it may take. The introduction of a new option to resolve disputes, therefore, is welcome.

It also is interesting to note that binding arbitration is the last resort, i.e., it is only when a MAP procedure has not been resolved for more than two years that a binding arbitration procedure can be initiated. The procedure will have to be triggered by the taxpayer that is the party most eager to reach a settlement, i.e., not to be taxed twice.

As mentioned above, upstream operators are familiar with binding arbitration since they generally already have recourse to an arbitration clause in their contracts for state disputes. However, in the case of double taxation disputes, the introduction of a similar mechanism in tax treaties will directly benefit the group companies and service providers. As a result, issues can be resolved or at the very least the parties will have assurances that if an issue was to arise, a clear and final answer ultimately would be provided.

All companies working in the oil and gas sector should monitor developments to identify the countries willing to sign the MLI and perhaps take this opportunity to settle ongoing disputes.

The Netherlands: Demise of the Dutch cooperative as a holding company?

Frank Tak and Guido Wijnans, Deloitte Netherlands

Historically, the Dutch cooperative has been widely used as a holding company in the energy and resources industry, in particular, by multinationals headquartered in the US, Canada, and China. Based on current law, distributions made by a Dutch cooperative to a non-European Union (EU) parent company are subject to Dutch dividend withholding tax only where anti-abuse rules apply. In contrast, distributions made to a non-EU parent company by other Dutch entities, such as a Dutch besloten vennootschap (BV), are subject to Dutch dividend withholding tax at a rate of 15 percent, unless that rate is reduced under an applicable tax treaty.

Against the backdrop of the G20/OECD BEPS project, EU state aid discussions, and the wish to maintain a business friendly environment, the Dutch government has reviewed the use of Dutch holding companies in international investment structures and, in particular, the use of cooperatives. The government now believes that the difference between the treatment of the Dutch cooperative and that of a BV can no longer be justified. In 2016, the government issued a letter to parliament that sets out its intention to publish legislative proposals in 2017 to eliminate the different tax treatment for cooperatives that are predominantly engaged in holding and/or financing activities with effect from 1 January 2018. From that date, such holding cooperatives would be treated for Dutch dividend withholding tax purposes in a manner similar to BVs engaged in the same activities.

In view of its desire to maintain a business friendly environment, the government simultaneously announced plans to broaden the current exemption from dividend withholding tax by introducing rules that would exempt dividend distributions made by a Dutch entity from Dutch dividend withholding tax if:

- The distributions are made in the context of an "active business structure";
- The parent company of the Dutch entity distributing the dividends is resident in a jurisdiction that has concluded a tax treaty with the Netherlands; and
- Anti-abuse rules (which are to be defined) do not apply.

This treatment would be in line with the principle that the Dutch government has maintained for many years when negotiating its tax treaties: that withholding taxes on dividends should be fully waived when the dividends are distributed in the context of active business structures that are non-abusive in nature.

Given this proposed broader exemption from Dutch dividend withholding tax, a Dutch BV potentially could replace the Dutch cooperative as a holding company in situations where the Netherlands has concluded a tax treaty with the jurisdiction of the parent company. In non-treaty situations, the current communications of the government seem to indicate the intention that a cooperative used for holding activities should no longer be treated differently from a BV for Dutch dividend withholding tax purposes, i.e., the 15 percent withholding tax rate would apply to dividends distributed by a cooperative as from 1 January 2018.

Since affected taxpayers may need to take action before the end of 2017, holding structures involving a Dutch cooperative should be reviewed as soon as possible.

Current tax rules relevant to holding companies

Dividend withholding tax – Dutch BV: As noted above, dividends paid by a Dutch BV to either a resident or a nonresident company are subject to a 15 percent Dutch dividend withholding tax.[1]

1. Dividends are not clearly defined in the relevant Dutch tax law. Instead, the term "income from shares" is used, which also includes other distributions/payments received by shareholders. For simplicity, the term "dividend" is used throughout this article to refer to all such distributions/payments. Further, the situation of a shareholder that qualifies as a transparent entity from a Dutch tax perspective is not discussed in this article.

A full exemption from the withholding tax may be available where the dividends are paid to a Dutch resident parent of the BV based on the application of certain domestic rules (e.g., the participation exemption regime or the fiscal unity regime).

In the case of a nonresident parent, the 15 percent rate may be reduced under an applicable treaty. Furthermore, Dutch tax law provides an exemption for dividends paid to a qualifying parent company that is resident in an EU or European Economic Area (EEA) member state pursuant to the Netherlands' implementation of the EU parent-subsidiary directive (PSD).

Dividend withholding tax – Dutch cooperative: Under current law, a Dutch cooperative is by default exempt from the obligation to withhold Dutch dividend withholding tax from the dividends it distributes unless anti-abuse rules apply.[2] Hence, if the structure concerned is not considered abusive, both the application of a tax treaty between the Netherlands and the country of residence of the nonresident parent company of the cooperative and (where the parent is resident in an EU/EEA member state), the exemption provided under the domestic law implementation of the PSD are essentially irrelevant for the tax treatment of dividends paid by a Dutch cooperative.

The non-abuse requirement was introduced in 2012, and basically requires that an "active business" or a headquarter company be established directly or indirectly above the Dutch cooperative, combined with an active business established directly or indirectly below the level of the Dutch cooperative. The cooperative then must perform a "linking function" between those two businesses. If those two requirements are met, the holding structure is not considered abusive. This rule is in line with the government's tax treaty negotiation principle: that withholding taxes on dividends should be fully waived where they are paid between entities operating in non-abusive active business structures.

This explains the widespread use of cooperatives by qualifying non-EU/EEA corporate and private equity investors[3] in circumstances where the treaty between the Netherlands and the investor's country of residence does not provide for a full exemption from Dutch dividend withholding tax, or where there is no applicable treaty between the Netherlands and the investor's country of residence.

Foreign taxpayer regime for nonresident parent companies

An anti-abuse requirement similar to that described above was introduced into the Dutch foreign taxpayer regime in 2012. This regime brings dividend income and capital gains derived from a Dutch cooperative or BV by a nonresident substantial shareholder[4] within the scope of the Dutch corporate income tax act. This regime does not apply when the structure concerned is not considered to be abusive, the test being similar to that applied in relation to Dutch cooperatives and their Dutch dividend withholding tax position.

2. This article does not discuss the situation in which a Dutch cooperative acquires a Dutch BV with an existing Dutch dividend withholding tax claim. This would typically be the case where the cooperative acquired a Dutch company with existing tainted retained earnings.

3. Private equity investors may also be considered to carry out an active business.

Introduction of the general anti-abuse rule

On 15 September 2015, the Dutch government published legislative proposals for the implementation of the amended EU parent-subsidiary directive (PSD), which took effect as from 1 January 2016. Among other things, the PSD amendments required EU member states to implement a general anti-avoidance rule (GAAR) by 31 December 2015. The GAAR was implemented in the Dutch foreign taxpayer regime for cooperatives and BVs, as well as in the Dividend Withholding Tax Act in relation to cooperatives.

Most of the amendments entail a technical alignment of the legislation with the policy that applied under the Dutch ruling practice in relation to the anti-abuse rule that was introduced in 2012. However, on the back of the enactment of the GAAR, a "non-artificial" requirement has explicitly been incorporated into Dutch tax law as an anti-abuse rule. This requirement is further defined in the explanatory notes, with a reference being made to the non-artificial requirement developed in EU case law (most notably, the decision of the Court of Justice of the European Union in the Cadbury Schweppes case, C-196/04).

The explanatory notes stipulate that a holding structure is considered to be artificial if there are no valid business reasons for the underlying commercial arrangements. Valid business reasons are deemed to exist if the direct foreign parent company of the Dutch cooperative or BV carries on an active business to which the interest in the Dutch entity can be allocated. Valid business reasons also are deemed to exist if the direct foreign parent company qualifies as a headquarter company (performing governance, management and/or financial activities). Thus, these types of structures are not considered artificial.

If a Dutch entity is indirectly held by such a foreign parent company, the direct foreign (intermediary) company holding the interest in the Dutch entity must meet certain substance requirements for the structure not to be considered artificial. These requirements include a resident director requirement, i.e. at least 50 percent of the board of directors must be tax residents of the country in which the holding company is located. This is regarded as the key policy change following the introduction of the GAAR in 2016.

Based on the current rules that apply to a cooperative, dividends paid by a cooperative to a foreign intermediary holding company may be subject to the 15 percent Dutch dividend withholding tax rate if the foreign parent has insufficient substance.

Government view on the use of Dutch holding companies

The Dutch government responded to the BEPS initiatives by emphasizing that the issues raised by that initiative are multilateral issues that need to be resolved at an international level. The government reiterated its view that the current substance requirements that apply to Dutch (intermediary) holding companies are robust in light of the BEPS standards. Nevertheless, the government has shown that it is sensitive to the criticisms and pressures reflecting BEPS concerns and, therefore, has decided to focus more on substance, transparency, and the exchange of information. Specifically in relation to the use of cooperatives as holding companies, the government has stated that it believes that the difference between the treatment for Dutch tax purposes of a Dutch cooperative and that of a Dutch BV can no longer be justified. In 2016, the Dutch government issued a letter to Dutch Parliament that set out its intention to publish legislative proposals in 2017 with a view to eliminating this difference by 2018 in the case of cooperatives that are predominantly engaged in holding and/or financing activities. Such holding cooperatives would then, in essence, be treated for Dutch dividend withholding tax purposes in the same way as BVs engaged in similar activities.

Proposed rules

Similar treatment of Dutch holding companies for Dutch dividend withholding tax purposes

A Dutch holding cooperative with a foreign parent company that holds an interest of 5% or more in that cooperative would be treated in a similar manner to that in which a Dutch BV is treated for dividend withholding tax purposes.[5] The current plans define a "holding cooperative" as a cooperative with at least 70% of whose activities consist of the "holding of participations" and/or the direct or indirect financing of affiliated entities and persons. Although a more detailed definition has not yet been provided, it may be expected that the assets held by, and the nature of the income derived by, the holding cooperative would be relevant.

5. Under the proposed rules, a non-holding cooperative would remain subject to different treatment for dividend withholding tax purposes.

For Dutch corporate law purposes, a cooperative and a BV will continue to be treated differently and no changes are expected in this regard. Using the cooperative as the holding company might, therefore, still be more advantageous than using a BV from a legal perspective because it affords more flexibility in relation to the liabilities of the parent company and with respect to profit distributions.

Broader withholding exemptions

At the same time, the current withholding exemptions would be broadened. In short, it appears that in the context of an active business structure, dividends distributed by a Dutch entity to a parent company established in a treaty-partner country will be exempt from Dutch dividend withholding tax subject to yet-to-be-defined domestic anti-abuse rules. It is likely that the new domestic anti-abuse rules will be based on anti-abuse rules established by EU case law (i.e., the non-artificial requirement) and the BEPS initiative (i.e., the principal purpose test).

Therefore, as of 2018, in determining whether Dutch dividend withholding tax will be levied in the context of an international holding structure, the focus will likely shift to the question of whether an applicable tax treaty is in place, along with whether an "active business test" is met and whether a new domestic anti-abuse rule applies. The legal form of Dutch holding companies will presumably cease to be a relevant consideration from a Dutch withholding tax perspective.

Implementation

A legislative proposal is expected to be available for consultation in the first half of 2017. The government's objective is for the measures to apply from 1 January 2018 at the latest. However, a new Dutch government is currently being formed following the general elections held in March 2017. The position of any Dutch government and its priorities is therefore as yet rather opaque.

Comments

As explained above, the government's fundamental position is that withholding tax on dividends should be waived when the dividends are distributed in the context of an active business structure that does not evidence any abuse. It appears that the intention is to achieve this result via domestic rules that would apply where a tax treaty is in place between the Netherlands and the country of residence of the dividend recipient, and the application of yet-to-be-defined anti-abuse rules is not triggered.

A full exemption from Dutch dividend withholding tax is not always achieved under the terms of an applicable tax treaty, because, for example, the tax treaty partner may require the inclusion of a limitation on benefits clause limiting the circumstances in which such full exemption is available (e.g. the U.S.).

The following simplified table provides an overview of certain treaties that currently do not provide for a 0 percent dividend withholding tax for dividends distributed to all parent companies in the context of an active business structure and the rates that apply to such distributions under those treaties.

Argentina	10%
Australia	15%
Brazil	15%
Canada	5%
China	5%
India	5%
New Zealand	15%
South Africa	5%
US	15% or 5%*

*The 0 percent rate is available only if certain criteria and limitation on benefits tests are met as provided in the treaty.

Provided there is a sufficient level of substance, parent companies located in these jurisdictions (and others that have a treaty in place with the Netherlands) may find that a Dutch holding company will again become a relevant alternative for their outbound investments if the proposed rules are enacted. Since a holding cooperative and a BV will be treated in the same way for Dutch dividend withholding tax purposes, it is expected that BVs will replace cooperatives in most international holding structures, based on non-tax considerations.

In non-treaty situations, the statements of the Dutch government seem to imply that using a cooperative for holding activities may cease to be more beneficial than using a BV for Dutch dividend withholding tax purposes, with the 15% withholding tax rate also applying to distributions made by a cooperative with effect from 2018. Given the expected short time frame between publication of the draft legislation and its enactment, investors should begin reviewing their holding structures where a Dutch cooperative is involved.

Gulf Corporation Council: Introduction of VAT in the Gulf States – considerations for the oil and gas industry

Matt Parkes, Elliot Severs and Adrienne D'Rose, Deloitte Middle East

The Gulf States have now approved the implementation of a VAT regime to be introduced by new domestic legislation at a rate of 5% in each of the six states forming the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates). Whilst at the time of writing legislation has yet to be published (either by the Council or by individual member states), some states have publicly announced an introduction date of 1 January 2018, and all states are working towards implementation in this timeframe.

The oil and gas sector remains a significant part of the economy of each Gulf State. Businesses include large national oil companies and their associated entities, international oil companies with local upstream and downstream operations (or those simply trading in the area), and service companies providing specialist resources and expertise to the industry. The introduction of VAT will have differing impacts for each type of industry participant.

Many in the sector anticipate that there may be some form of VAT relief for the oil and gas industry. Even if this is the case, VAT is still likely to have an impact on all businesses. We explain below some of the major potential impacts on businesses across the oil and gas supply chain. In particular, we explore the effect of VAT on cash flow, which looks to be an important issue for the sector, and look at some complexities of cross-border operations. Finally, we explore two practical issues for companies in the upstream sector.

Options for VAT relief in the oil and gas sector

Whilst the fall in oil prices has had a significant impact, oil and gas remains an important industry in each of the Gulf States. Many expect that governments will not apply VAT across the entire sector, but instead will provide some form of relief (such as an exemption or zero-rate) to reduce the burden on companies.

Even if some form of VAT relief does apply, this is unlikely to mean that VAT will have no effect on industry participants—companies should be sure they understand any special rules that may apply. There are varying potential forms of relief that may have significantly different financial and operational implications. Based on approaches seen in other jurisdictions, some of the potential treatments and their implications are explored below.

The default assumption is that VAT will be due on domestic transactions under usual rules. In fact, many jurisdictions do not apply any special VAT treatment to upstream or downstream activities. In theory, VAT is charged at the standard rate on the sale of products and on services provided to oil companies. Despite this, in practice, the international nature of the industry, both for extraction activities and sales of crude/product, often result in VAT not being applied under the standard VAT rules. For example, a zero rate generally applies for products exported outside of a country, and exploration activities carried out in a country's exclusive economic zone can fall outside a country's VAT territory. Most European jurisdictions follow this model.

Applying VAT in this way is conceptually straightforward, but businesses must address international complexities of their operations and additional cash flow requirements where VAT does arise in the supply chain.

For oil and gas-related businesses, some countries apply a zero rate to certain activities or sales of certain products, whilst other countries apply a sector-wide exemption. A regime with zero rating is often viewed as favorable for suppliers in the industry, but businesses making predominantly zero-rated supplies must anticipate the cash flow effects of paying VAT to suppliers, values that often can be significant for capital and operational expenditure in the sector, and seeking VAT refunds from authorities.

Likewise, the sector-wide exemptions applying in other countries to suppliers as well as customers often require extensive administrative processes to allow service providers in the industry to charge without VAT.

Even where law does allow a zero rate or other relief, the scope of the relief must be carefully considered by sector participants to ensure they understand their position. A distinction may exist to restrict the zero rate to certain products or certain upstream activities. Businesses should carefully examine the extent to which their operations in each country are covered by domestic reliefs or special rules.

Cash flow effects will be a key consideration

Whether a sector relief described above applies to domestic transactions or not, the cash flow implications of VAT need to be considered by all businesses operating in the sector. Businesses making predominantly zero-rated or non-VAT taxable supplies (including those making sales for export) can expect to be in a regular VAT refund position, since credits for VAT on purchases will exceed VAT collected on sales. Even at a five percent rate, the impact of VAT will be significant for large commodity transactions and capital expenditure. The timeframes for monetizing VAT receivable balances will depend on individual tax authority practices. It is not yet known whether the new VAT rules will require a taxpayer to submit a refund claim with supporting documentation, or whether there will be a standard timeframe for authorities to verify or audit a VAT repayable position.

International supply chains bring complexity

Oil and gas companies traditionally have faced challenges in managing VAT obligations across international supply chains. The sale and purchase of crude and refined products gives rise to a technical VAT obligation in the country where each transaction takes place. This can often result in unexpected VAT registration requirements or obligations to charge VAT where products are purchased and sold in overseas jurisdictions. Businesses must ensure they understand the VAT landscape and their obligations in any country where they have operations, as well as in any countries where they transact.

Whilst the concept of a zero rate for exported products in international practice generally reduces VAT costs for international movements of products or equipment, exporters must take care to collect and maintain appropriate documentation to support zero rating in the event of scrutiny by the tax authorities. This process should be sufficiently robust to enable timely access to documents, even where another party (such as a freight agent or a customer) is responsible for carrying out the export formalities.

Exploration and development phase – recovery and registration

The oil and gas project lifecycle may involve a long period of investment in exploration and, in the case of a commercial discovery, development until the asset (e.g., the oil or gas field) is in production phase. Until this time, the business is unlikely to make any supplies from that asset that would give rise to a corresponding requirement for VAT registration or a right to recover VAT on costs.

Many jurisdictions allow businesses to be VAT registered and to recover VAT incurred during these preliminary phases; otherwise, VAT incurred could form an additional irrecoverable cost and discourage investment. Ultimately, the VAT recovery position during the exploration and development phase will depend on the country-specific rules. If upfront registration is not possible in a particular country, businesses should explore what steps may be possible to ensure exploration and development costs are incurred by a company (or group) that is able to recover the VAT. In any case, forecasts for projects may need to include contingencies for irrecoverable VAT.

Cost sharing in joint venture arrangements

Many upstream projects are carried out under joint venture agreements, with multiple entities holding interests in the project and contributing their share in the exploration, development, and operating costs. Such a sharing of costs between entities (whether within a group or between third parties) is likely to be viewed as separate transactions on which VAT should be charged, unless an exemption applies. The VAT treatment of cost-sharing arrangements often can be unclear where a charge is made for a share in a bundle of costs, even when the majority of costs may not be liable for VAT per se (e.g., work carried out on an offshore rig outside the VAT territory). In such cases, the VAT treatment for the bundle of services may revert to the default "taxable" position. Upstream companies involved in joint venture agreements should review their contractual positions and ensure that existing agreements are appropriate once VAT is introduced in the Gulf States.

Conclusion

The oil and gas sector has a number of specific complexities, and the introduction of VAT across the Gulf States likely will create additional compliance requirements and potential costs across the supply chain. Whilst VAT is not intended to be an overall cost to businesses, it is almost certain that industry participants will feel a cash flow effect and will be required to comply with additional administrative obligations. Practically, VAT inefficiencies may result in a cost being borne at some stage in the supply chain. Upstream and downstream businesses should examine their operations and existing arrangements to determine how VAT may affect them, and to ensure they are ready for the new world of VAT.

Implementation of VAT for a business is a significant transformation project, and with a short time frame until VAT is introduced in the Gulf States, most businesses already have commenced work to be VAT ready by January 2018. Deloitte has set up a dedicated VAT implementation team, with many specialists in the oil and gas industry, and we are currently assisting businesses in the sector to identify and quantify the impact of VAT on their operations, to plan their VAT transformation process, and to make their systems and processes ready for VAT.

U.S.: Tax reform on the horizon?

Jeffery M. Wright, Deloitte U.S.

With the recent U.S. national elections, tax reform has emerged as a top priority for both the legislative and executive branches of the U.S. government in 2017. While comprehensive tax reform has been a constant topic of discussion, Republican control of the executive and legislative branches starting in 2017 makes real reform a possibility. Depending on the ultimate structure of any tax reform efforts and the nature of a particular oil and gas company's operations, changes to the tax rules could have a very significant impact, potentially favorable for some and unfavorable for others.

President Donald Trump's address to a joint session of Congress on 28 February 2017 laid out tenets of tax reform that are broadly consistent with plans advanced by House Republican leaders, but the speech did not provide specific policy directives in some key areas where Republican lawmakers are struggling to reach consensus.

Trump clearly echoed calls from the congressional Republican playbook when he stated that his administration is developing "historic tax reform that will reduce the tax rate on our companies so they can compete and thrive anywhere and with anyone," as well as "provide massive tax relief for the middle class." Less clear, however, was his position on the hot-button issue of the border-adjustment tax proposed by House Speaker Paul Ryan (Republican, Wisconsin) and Ways and Means Committee Chairman Kevin Brady (Republican, Texas), in the tax reform blueprint they released in June 2016.

The blueprint proposes to move the U.S. from its current worldwide tax regime to a territorial system for taxing domestic multinationals and to implement a new destination-based cash flow tax (DBCFT). Specifically, the DBCFT provides for border adjustments through a not-yet-specified mechanism that would serve to eliminate U.S. tax on products, services, and intangibles exported abroad (regardless of their production location) and impose a 20 percent U.S. tax on products, services, and intangibles imported into the U.S. (also regardless of production location).

The border adjusted tax, which has not yet been released as a discussion draft or an introduced bill and is described only in general terms in the House Republican blueprint, has become the focus of an intensive lobbying battle within the business community, with retailers, oil refiners, and other import-dependent industry sectors on one side, and export-focused businesses on the other. A number of Senate Republicans have signaled their concerns about (or, in some cases, outright opposition to), the proposal, creating an uphill path for supporters.

Stakeholders have been looking for a clear signal from the president on whether or not he supports the House Republican proposal. In some media interviews, Trump has appeared to dismiss the proposal as "too complicated," but in others, he has suggested that it remains under discussion as an option for tax reform. Meanwhile, Treasury Secretary Steven Mnuchin, indicated in a Fox News interview on 26 February 2017 that the administration is looking at a reciprocal tax, something apparently distinct from the House Republican proposal that is intended to ensure "that other countries treat us the way we're treating them."

The White House raised expectations of a definitive answer in early February when press secretary, Sean Spicer, said the administration would soon release "the outline of a comprehensive tax plan." The president has made similar mentions in the weeks since, but congressional anticipation of a detailed document appears to have been tempered.

In his address to Congress, Trump touched only broadly on border tax issues, calling for "a level playing field for American companies and workers" and noting that "when we ship products out of America, many other countries make us pay very high tariffs and taxes, but when foreign companies ship their products into America, we charge them almost nothing."

This passage was not contrary to the language used in recent months by Speaker Ryan and Ways and Means Chairman Brady to sell their congressional colleagues

on the border-adjusted tax, but it stopped short of specifically advocating the House plan. When asked by a reporter shortly after the speech whether Trump had effectively endorsed the proposed border adjusted tax, newly minted Commerce Secretary Wilbur Ross said, "No, he did not. What he addressed was the issue that needs to be solved, which is there's inequitable treatment of the U.S."

For now, Brady and Ryan continue to make the case for their proposal, and many others wait on legislative language to more fully assess the impact such a tax would have.

Across the Capitol, Sen. John Cornyn (Republican, Texas) a tax writer and the majority whip, said on 2 March 2017 that Senate Republicans are looking at alternatives to the border-adjusted tax because it remains contentious.

The following tables contain a brief summary of some of the key domestic and international provisions discussed thus far that could meaningfully impact many oil and gas companies:

Domestic reform proposals

Provision	Current Law	President Trump [1] (2015 Proposal)	House Republican Blueprint	Camp II [2]
Top corporate rate	35%	15%	20%	25%
Research credit	Generally allows either a 20% credit for qualifying research expenses in excess of a base amount, or a 14% alternative simplified credit.	Retain research credit, but repeal most other business tax expenditures.	Retain credit; Ways and Means Committee will "evaluate options" to make it "more effective and efficient".	Research credit (alternative simplified credit) would be permanent.
IRC §199 deduction and [3] other business deductions	Up to 9% deduction under IRC §199 for certain income attributable to domestic production activities.	Repeal most business tax expenditures except for the research credit.	Repeal IRC §199.	Repeal of IRC §199 phased out over two years (6% in year one, 3% in year two); repeal of percentage depletion.
Capital cost recovery	Taxpayers generally recover costs under the Modified Accelerated Cost Recovery System (MACRS).	Firms engaged in US manufacturing may elect to deduct the full cost of their capital investments in year one; option revocable within first 36 months.	Full expensing in year one of all assets, tangible and intangible, other than land.	Depreciation would be computed using straight-line method with longer recovery periods (similar to ADS).[4]
Net operating loss (NOL)	Available for 2-year carryback and 20-year carryforward.	No Change Specified.	NOLs carried forward indefinitely, annual future deduction is limited to 90% of net taxable income. NOL carrybacks will no longer be permitted.	NOL would only be permitted to offset 90% of the corporation's taxable income in the carryback or carryforward year.
Interest expense	Generally deductible	Businesses that elect full expensing in year one for all costs will lose their ability to deduct net interest expense.	Interest expense deductible against interest income, but no current deduction for net interest expense; net interest expense may be carried forward indefinitely.	Modifies IRC §163(j) with new thin cap rules; limit for adjusted taxable income reduced from 50% to 40%.

1. Based on information released by the Trump campaign. This does not reflect his formal proposals which have not been released at the time of writing
2. Discussion draft of a comprehensive tax reform proposed by former House Ways and Moans Committee chair Dave Camp (Republican, Michigan). Although never formally introduced in the House, this could serve as a template for future tax reforms
3. A special tax deduction that provides enhanced tax benefits for certain domestic production activities. It has a number of limitations and complex qualification criteria
4. ADS – Alternative Depreciation System: US taxpayers may elect to use an alternative time period over which to take tax relief for costs of depreciable assets

International tax reform – scope of U.S. international taxation

	Current Law	President Trump (2015 Proposal)	House GOP Blue Print (with Border Adjustment)	Camp II Proposal [1]
US Co's U.S. sales/ service income	Taxable	Taxable	Taxable	Taxable
US Co's foreign sales/ services income	Taxable	Taxable	Exempt	Taxable
Payment to non-US taxpayer for cost of goods sold (COGS)	Deductible	Deductible	NOT deductible	Deductible
Dividends received	Taxable	N/A [2]	Exemption [3]	Partial Exemption [4]
Foreign sub's sales/ services sub F income	Taxable [5]	N/A	Exempt	Sales Income Taxable
Foreign sub's passive sub F income	Taxable	N/A	Taxable	Taxable
Foreign sub's non-sub F income	Deferral [6]	N/A 7	Exempt	Potentially Taxable New Category of Intangible Sub F Income

1. The Camp proposed Subpart F rules are complicated and beyond the scope of this presentation
2. All income is included currently under President Trump's 2015 Proposal, no taxable dividends
3. Proposed 100% Participation Exemption
4. Proposed 95% Participation Exemption for 10%-owned Subsidiaries
5. Deemed Inclusion to US Co.
6. Potentially subject to US Tax upon Future Distribution to US Co
7. No Subpart F under President Trump's 2015 Proposal, all income is included without deferral

As the tables illustrate, many of the potential areas of change could be significant to companies with oil and gas operations. While the various proposals outlined thus far vary in important ways, one key consistency is the focus around lowering tax rates for business and individual taxpayers, while simultaneously broadening the base through limiting, and in some cases eliminating, some longstanding tax deductions, credits, and incentives.

The breadth of these potential changes are motivating many taxpayers to take steps to assess the potential impact on their business operations and to take proactive steps to best posture their organization prospectively.

As the above discussion illustrates, the ultimate outcome of potential U.S. tax reform is far from certain. The momentum, however, is significant. As these potential tax changes may have a major impact, it is an important strategic issue that merits close monitoring and an appropriate level of readiness analysis to limit any unwanted surprises. Deloitte's U.S. tax team is monitoring developments closely and we will publish further comments as the proposals emerge.

Global oil & gas tax leaders

Chris Roberge
Global oil & gas tax Leader | Deloitte Asia Pacific
Tel: +852 2852 5627
Email: chrisroberge@deloitte.com

Julian Small
Partner | Deloitte UK
Tel: +44 20 7007 1853
Email: jsmall@deloitte.co.uk

Daniel Caracciolo
Partner | Deloitte Argentina
Tel: +54 11 4320 2700
Email: dcaracciolo@deloitte.com

Jonathan Schneider
Partner | Deloitte Australia
Tel: +61 8 9365 7315
Email: joschneider@deloitte.com.au

Carlos Vivas
Partner | Deloitte Brazil
Tel: +55 21 3981 0482
Email: cavivas@deloitte.com

Andrew Zhu
Partner | Deloitte China
Tel: +86 10 8520 7508
Email: andzhu@deloitte.com.cn

Andrey Panin
Partner | Deloitte CIS
Tel: +74 957 870 600
Email: apanin@deloitte.ru

Dmitry Logunov
Partner | Deloitte East Africa
Tel: +25 522 216 9000
Email: dmlogunov@deloitte.co.tz

Toh Hong Pier
Executive Director | Deloitte Malaysia
Tel: +60 3 7610 8808
Email: htoh@deloitte.com

Alex law
Partner | Deloitte Middle East
Tel: +971 4 506 4700
Email: alexlaw@deloitte.com

Frank Tak
Partner | Deloitte Netherlands
Tel: +31 8 8288 0334
Email: ftak@deloitte.nl

Oluseye Arowolo
Partner | Deloitte Nigeria
Tel: +234 1904 1723
Email: oarowolo@deloitte.com

Per Evers
Partner | Deloitte Norway
Tel: +47 2327 9636
Email: peevers@deloitte.no

Roman Webber
Partner | Deloitte UK
Tel: +44 20 7007 1806
Email: rwebber@deloitte.co.uk

Jeff Wright
Partner | Deloitte US
Tel:+ 1 713 982 4940
Email: jeffwright@deloitte.com

Alejandro Gomez
Partner | Deloitte Venezuela
Tel: +58 212 206 8730
Email: algomez@deloitte.com

Article contributors

Deloitte has tax professionals who specialize in oil and gas related matters across the global member network. For further information relating to any of the areas covered in this edition of the newsletter, please reach out to any of the contacts listed below.

Bill Page (Editor)
Senior Advisor African Projects | Deloitte UK
Tel: +44 20 7007 6937
Email: bpage@deloitte.co.uk

Axelle Brière
Associate Director | Deloitte UK
Tel: +44 20 7303 0313
Email: abriere@deloitte.co.uk

Frank Tak
Partner | Deloitte Netherlands
Tel: +31 88 288 0334
Email: FTak@deloitte.nl

Guido Wijnans
Senior manager | Deloitte Netherlands
Tel: +31 88 288 4323
Email: GWijnans@deloitte.nl

Jeffery M Wright
Partner | Deloitte US
Tel: +58 212 206 8730
Email: jeffwright@deloitte.com

Matt Parkes
Director | Deloitte Middle East
Tel: +44 20 7007 1090
Email: maparkes@deloitte.co.uk

Emily Catmur
Consultant | Deloitte UK
Tel: +44 20 7303 7705
Email: ecatmur@deloitte.co.uk

Geoffrey Cann
Director | Deloitte Canada
Tel: +1 403 261 8133
Email: gcann@deloitte.ca

Elliot Severs
Senior manager | Deloitte Middle East
Tel: +971 4 5064 700
Email: esevers@deloitte.com

Adrienne D'Rose
Senior manager | Deloitte Middle East
Tel: +971 4 5064 700
Email: addrose@deloitte.com

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