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Global oil & gas tax newsletter
Views from around the world
June 2016
Editor’s introduction

Bill Page, Deloitte UK

Welcome to the June 2016 edition of our global oil and gas tax newsletter.

In this issue, continuing the theme from our last edition, we look at the impact that the OECD base erosion and profit shifting (BEPS) project may have on the oil and gas sector, with an overview of the progress of the initiative to date and an article focusing on action 4 (Limiting base erosion involving interest deductions and other financial payments). We also look at the steps being taken by two significant hydrocarbon producer countries (Iran and Mexico) to promote investment in their upstream industries, and then conclude the issue with a round-up of recent developments from Nigeria, Kazakhstan, Tanzania and the UK.

If there is a common theme in these diverse articles, it is the challenges presented by the steepest fall in oil prices in a generation. While the BEPS initiative aims at curbing tax planning for all industries, the proposals under action 4 to restrict interest deductions to a fixed proportion of EBITDA are likely to have a particularly significant impact on the oil and gas industry given the current environment of declining earnings, long pay-back periods typical for upstream projects, and the widespread use of project finance and similar structures, which are linked to future revenue streams rather than current financial performance. Delays in finalizing the new upstream fiscal regime in Iran, and the introduction of a new structure to help monetize mature assets in Mexico, seem to reflect governments’ concern that they take the appropriate steps to encourage investment in response to the drastically reduced appetite for new projects.

Additionally, I’d like to take this opportunity to introduce our new global oil and gas tax and legal leader, Chris Roberge. Chris is a Canadian, currently based in our Hong Kong office where he also leads Deloitte’s team focusing on the Chinese oil and gas market. Chris has been part of the Deloitte network since 1995 and worked in the Calgary office before moving to Asia. Chris has an extensive background in international tax and business matters and has significant experience working with production sharing contracts, specialty oil and gas tax regimes, investment policies and other regulatory matters. Chris acts as a key adviser to many of the world’s largest national and international oil companies.

Some words from Chris

The global oil and gas industry has faced a major challenge in the last two years, but this is an industry accustomed to dealing with challenges. Clearly, industry participants will be put to the test in complying with this new world of taxation, taking into account both the regulatory and socio-economic expectations. Never before has a global mind-set underpinned with business practicality and agility been so important.

It is a privilege to lead Deloitte’s global oil and gas tax and legal practitioners as they help our clients deal with the new reality of lower oil and gas prices and increased scrutiny on the industry. I’d like to thank my predecessor, Julian Small, for his contribution to our global network and wish him well as he continues his key role as leader of our UK firm’s team focusing on the energy and resources industries. I look forward to working with our clients as we successfully navigate the changes in our industry.

Chris Roberge
Global Oil & Gas Tax & Legal Leader
BEPS Actions: An update

Roman Webber and Simon Lee, Deloitte UK

Background
In October 2015, ahead of the G20 Finance Ministers’ meeting in Lima, the OECD Secretariat published a batch of 13 reports and an Explanatory Statement outlining consensus actions under the BEPS project. The release signalled a significant milestone in a process that involved the direct input of an impressive 62 countries.

Since the Lima meeting, some countries have commenced the implementation of policy changes, while others have adopted a more passive approach, closely monitoring the efforts of the early adopters.

While all of the BEPS measures will impact the full breadth of the economy, oil and gas companies will have had their interests considerably piqued by the proposed capped interest restrictions under action 4, which could disproportionately impact long lead term projects where financing costs precede earnings.

Two recurring questions remain on the implementation of each BEPS action: When will they actually be implemented and which countries will move first? Given the close involvement of its member states in the formation of the actions, the EU could lead the way, implementing BEPS actions across each of its 28 members. In June 2015, the European Commission published a Communication on a Fair and Efficient Corporate Tax System in the European Union, which set out how the BEPS measures could be implemented within the EU, and in January 2016, the Commission released an anti-tax avoidance package designed to assist EU member states in taking coordinated action against tax avoidance in the EU.


BEPS – Description of actions

<table>
<thead>
<tr>
<th>Action</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Digital economy Action 1 addresses the tax challenges of the digital economy and aims to identify and address the main challenges that the digital economy poses for the existing international tax rules.</td>
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<td>2</td>
<td>Hybrids Action 2 aims to neutralize the effects of hybrid mismatch arrangements. The OECD intends to do this by making changes to the model tax convention and providing recommendations on the design of domestic rules to prevent hybrids from being a source of ‘double non-taxation’.</td>
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<tr>
<td>3</td>
<td>Controlled foreign companies Action 3 aims to develop recommendations regarding the design and strengthening of controlled foreign company rules, to address concerns over the possibility of creating affiliated non-resident taxpayers and routing income of a resident enterprise through the non-resident affiliate to reduce or avoid taxation.</td>
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<tr>
<td>4</td>
<td>Interest deductions Action 4 aims to limit base erosion via interest deductions. Recommendations are expected to be published for domestic law limitations on tax deductions for both related and unrelated party interest expense and economically equivalent payments. The workstream will also develop guidance for the transfer pricing of debt.</td>
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<tr>
<td>5</td>
<td>Harmful tax practices Action 5 aims to identify and counter harmful tax practices, taking into account transparency and substance. The Action Plan will look at developing recommendations on the definition of harmful tax practices, and developing a strategy to expand to non-OECD members.</td>
</tr>
<tr>
<td>6</td>
<td>Prevent treaty abuse Action 6 aims to prevent treaty abuse, through developing model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.</td>
</tr>
<tr>
<td>7</td>
<td>Permanent establishment status Action 7 aims to prevent the artificial avoidance of PE status, by redefining the threshold for creating a PE to prevent base erosion and profit shifting. The work includes a focus on the use of commissionaires and keeps some specific activity exemptions, including for warehousing.</td>
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<td>8</td>
<td>Transfer pricing – intangibles</td>
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<td>Transfer pricing – risk and capital</td>
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<td>BEPS data collection</td>
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<td>13</td>
<td>Transfer pricing documentation</td>
</tr>
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<td>14</td>
<td>Dispute resolution</td>
</tr>
<tr>
<td>15</td>
<td>Multilateral instrument</td>
</tr>
</tbody>
</table>

**Initial actions to be implemented**

The first BEPS actions to be implemented will be those dealing with the new transfer pricing approach (actions 8-10). The OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* provide the main guidance on the application of arm’s length pricing. Although the new consolidated version of the guidelines will not be published until 2017, tax authorities across the globe already have started to use material released in the public consultation in their approaches to open cases. The revised method will require multinationals to start their functional analyses afresh, ensuring that the allocation of operational profits aligns more closely to the economic activities giving rise to them. This will mean that entities must be able to control the risks that generate potential rewards and that mere legal ownership of an intangible asset will not be sufficient to generate a significant return.

While all of the BEPS measures will impact the full breadth of the economy, oil and gas companies will have had their interests considerably piqued by the proposed capped interest restrictions under action 4.

The transfer pricing actions will be followed by the implementation of country-by-country (CbC) reporting (action 13). All of the main parent company countries have committed to CbC reporting and other countries will receive the benefit of additional information for risk assessment, provided they have concluded a tax treaty or a tax information exchange agreement with the country in which the parent company is resident, or where both countries have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*.

The final action that will be implemented in the near term affects countries that offer beneficial intellectual property regimes (action 5, Countering Harmful Tax Practices). In future, patent box incentives will be granted only where the related research and development is conducted in that same country in accordance with the “nexus” approach.
The UK has included the introduction of a BEPS-compliant patent box regime in the current Finance Bill legislation, and Germany, Luxembourg, Ireland and the US are expected to follow suit.

**Actions likely to take effect as from 2017 or later**

Two important actions – Hybrid Mismatches (action 2) and Interest Restrictions (action 4) – will require domestic legislation in each country of adoption. The OECD Working Party looking at these issues has provided over 400 pages of guidance to assist countries in developing legislation to counter hybrids (i.e. instruments or entities which, through different treatment in two countries, achieve two deductions for the same economic expense or one deduction without equivalent income recognition). The approach to hybrids will mean that they will no longer be effective even if only one country enacts the anti-hybrid rules. One of the key challenges tax authorities will face will be collecting sufficient information to demonstrate there is a hybrid effect. The UK has included in its current Finance Bill legislation to counteract hybrids from 1 January 2017; few other countries have yet offered public support, although some (e.g. France) consider that hybrids are already ineffective under their existing domestic law.

The recommendations for restrictions on interest deductions (action 4) provide that countries should limit interest deductions to a fixed percentage of earnings before interest, tax and depreciation (EBITDA). The cap is to be applied at a figure in the range of 10%-30%. Countries have the option to offer a fall-back to a group-wide ratio of third-party net interest expense in the event this is higher than the cap. Other options put forward include a de minimis limit to exclude low levels of debt and the ability to carry excess interest forward and back. Additionally, third-party debt to finance public-benefit projects may be excluded, subject to conditions. The UK has consulted on the application of this action and the Business Tax Road Map published with Budget 2016 confirmed that a cap of 30% would apply as from 1 April 2017, collecting close to GBP 990 million for the UK tax authorities each year from the introduction of the proposed measure. Oil and gas companies will take encouragement from the reassurance from the UK government that it will consult to ensure that existing commercial arrangements within the oil and gas ring-fence are not adversely affected by these changes.

Countries adopting a different tack include Australia, which has indicated that it will not implement a further restriction on financing deductions, and many European countries that consider their existing rules on financing to adequately satisfy the action. The US Congress and the Treasury Department both would like to limit interest deductions, but Congress is not expected to legislate except as part of a broader corporate tax reform.

**Actions requiring amendments to double tax treaties**

The “multilateral instrument” is intended to allow the effective modification of many tax treaties, and the current plan is that the instrument will be negotiated during 2016 and then be available for countries to ratify. It is expected that there will be a number of options within the multilateral instrument that will grant participating countries the freedom to make different choices.

The changes to the permanent establishment article are intended to lower the threshold for recognizing a taxable presence. The first focus is reducing the importance of the place where a contract is legally entered into, followed by limits on the use of exemptions “...to ensure that profits derived from core activities performed in a country can be taxed in that country.” The exemptions in article 5(4) of the OECD model tax treaty will be modified to ensure that each of the exceptions is restricted to activities that are of a “preparatory or auxiliary” character.

This will be supplemented by an “anti-fragmentation” rule that limits the ability of multinationals to split activities to avoid a taxable presence.

Additionally, to provide greater certainty about the determination of profits to be attributed to a permanent establishment, follow-up work on attribution of profits issues will be carried out, with guidance expected to be issued before the end of 2016.
The treaty abuse action arises from the concern that double tax treaties may be used to allow treaty benefits to be granted in unintended circumstances. Countries have agreed to include anti-abuse provisions in their tax treaties. They also have agreed that some flexibility in the implementation of such rules is necessary to allow the provisions to be adapted to the specific circumstances of each country during the negotiating process. The approaches put forward include limitation on benefits rules (already used by Japan and the US) and principal purpose tests (used by many other countries, including the UK).

The dispute resolution action (action 14) will be very important, with the G20/OECD noting that: “Double taxation would harm multinationals which have contributed to boosting trade and investment around the world... Double taxation would also increase the cost of capital and could deter investment in the economies concerned.”

The measures developed under action 14 aim to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP). Statistics on MAPs show that at the end of 2014, there were over 5,400 cases between OECD members and four partner countries, including 2,266 new cases in 2014 alone. The new approach will ensure that treaty obligations related to the MAP are fully implemented in good faith and that cases are resolved in a timely manner. A further protection will be a scheme of peer-based monitoring reporting through the Committee on Fiscal Affairs to the G20, which will help facilitate consistent application of the MAP in future.

The BEPS project successfully achieved the 2015 requirement for reports on the 15 actions to be finalised for approval by the G20 in November. Work is proceeding on global adoption of the new approaches and the recent agreement by the EU of the Anti-Tax Avoidance Directive (ATAD) will see some of the actions translated in national law across EU countries from 2019. The ATAD covers interest limitations (action 4); CFC rules (action 3); and an intra-EU adoption of Hybrid Mismatches (action 2). New approaches to transfer pricing analysis and documentation are already adopted by many countries.

The OECD has been requested to extend the BEPS actions to a wider range of countries, through the adoption of an inclusive Framework. Over 90 countries are expected to participate in the first meeting in Kyoto at the beginning of July. Ninety-six jurisdictions are part of the ad hoc group on the Multilateral Instrument and should all agree to ratify that instrument from 2017 more than 2,000 tax treaties would be changed. Detailed work continues on some of the actions, which is important in translating high-level actions to detailed implementation. This is expected to continue until 2018 but has been delayed due to inevitable changes in personnel and a recognition of the underlying complexity of some of the actions.
BEPS Action 4: Limiting base erosion involving interest deductions and other financial payments

Chris Roberge, Deloitte China

At their meeting in November 2012, the G20 issued a remit to the OECD to address “Base Erosion and Profit Shifting” (BEPS). The term “BEPS” encompasses tax planning strategies that are perceived to be used by multinational groups of companies to exploit gaps and mismatches in domestic and international tax rules with the intention of artificially shifting profits to low or no-tax jurisdictions where there is little or no real economic activity. As noted in the previous article, the OECD issued a BEPS action plan identifying 15 key areas to be addressed.

This article focuses on action 4, which outlines a series of recommendations to restrict the ability of multinational groups to reduce tax using interest and similar payments.

What is the concern?
The G20 and OECD governments perceive that interest flows (and, in particular, interest flows between related parties) are a technique frequently used in international tax planning. A key concern is that multinational groups seek to concentrate interest deductions in high-tax entities or jurisdictions, even where this may be disproportionate to the level of economic activity in that jurisdiction and/or the group’s overall external interest burden.

The proposals
The final report on action 4 recommends that countries should include additional provisions in their domestic laws to counteract tax base erosion through interest and other financing expenses. The key recommendation is that the net interest expense deductible for tax purposes should not exceed a certain proportion of earnings in the relevant entity/jurisdiction. The restriction is to apply regardless of whether debt is from related or unrelated parties.

The suggestion is that a range of 10% to 30% of earnings before taxes, depreciation and amortization (EBITDA) should be adopted, with discretion for countries within this recommended range. Net interest expense exceeding the limit would not be deductible, although countries potentially could allow excess deductions or capacity to be available for carry forward (or carry back) if there are future (or past) periods where deductions could be utilized.

The report also considers the possibility of using a ratio of debt-to-total-asset value, excluding assets that do not produce taxable income (such as shares where dividends are subject to a participation exemption). This approach is considered less desirable because asset values may vary significantly based on accounting policies that are at the discretion of management.

The final report on action 4 recommends certain relieving provisions, including the possibility that countries could permit entities to deduct a higher level of interest expense to the extent the interest does not exceed the worldwide group’s net interest to EBITDA ratio. This would assist groups whose external leverage ratio exceeds the 10% to 30% rates recommended to be adopted by individual countries. The report also suggests de minimis thresholds to exclude low risk entities. Another carve-out that may be relevant for the upstream industry is the option for countries to exclude certain long-term public benefit projects that are financed on a non-recourse basis. Though the explanation included in the report is primarily in terms of public-private partnerships for large infrastructure projects, the definition given could readily be applied to a project under a production sharing contract or similar arrangement.
It should be noted that the final report on action 4 does not address in any detail the interaction of the proposed denial or deferral of relief for interest expense with the obligation to withhold tax at source in respect of payments of interest, nor does it consider the recognition of interest income in the hands of a lender. Depending on how countries implement the action 4 recommendations, the implication is that interest expense in excess of a statutory cap may not be deductible, but still may give rise to withholding tax and still will be taxable as income in the hands of a group finance company.

To have any effect, the recommendations in action 4 would need to be embedded into domestic law and, therefore, the timing of implementation across jurisdictions will inevitably vary. By way of example, the UK historically has had a relatively generous approach to interest deductibility (including permitting interest to be deducted on borrowings that effectively finance non-UK investments). Following the BEPS recommendations, the UK government has undertaken a consultation process on the potential introduction of interest restrictions, indicating that the final measures are expected to take effect from 1 April 2017. Canada has implemented similar rules.

**Application to the oil and gas sector**
The oil and gas industry is capital-intensive, global and, as a result of commodity price fluctuations and exploration risks, volatile. This could lead to unpredictable outcomes from the implementation of the action 4 recommendations if these are not adapted to the industry’s specific circumstances and if there are wide variations in the approaches taken by different countries. It also is important to note that, for many oil and gas companies, the strength of the balance sheet has been a much more important key performance indicator than the income statement.

The new approach recommends a shifting of interest expense limitation from a balance sheet approach (debt-to-equity) to a cash flow approach (EBITDA), and this may cause problems, particularly for smaller, exploration-focused companies.

Recommendations based on EBITDA are likely to be troublesome for this industry. The extreme volatility in commodity prices can result in companies experiencing very high EBITDA one year followed by very low EBITDA the next. This does not fit well with a fixed ratio of interest to EBITDA within a 10% to 30% band. To address this, it will be important that countries adopt the OECD suggestions that excess interest expenses and excess interest limitations may be carried forward or back to ensure some “smoothing” of the impact. The EBITDA linked cap also will be affected by how companies treat their exploration expenses and any impairments. The exploration expenses and any impairments for many companies will be “above the line” and thus included in EBITDA. This could substantially reduce their EBITDA in some years and correspondingly reduce their allowable interest deduction. Arguably, this would unfairly impact the oil and gas industry compared to other industries.

The taxation regimes in the upstream industry are quite different to those for other businesses. Methods used by governments to capture economic rent embrace a wide variety of fiscal tools, including income tax, royalties, excess profits taxes and production sharing arrangements. The differing legal and accounting consequences of these may have a significant impact on the calculation of EBITDA and, hence, on companies’ ability to deduct its interest expense. Consider the following simplified example:*  

<table>
<thead>
<tr>
<th></th>
<th>COUNTRY A</th>
<th>COUNTRY B</th>
<th>COUNTRY C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production sharing</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income tax &amp; royalty</td>
<td>$-350</td>
<td>$-350</td>
<td>$-350</td>
</tr>
<tr>
<td>Income tax only</td>
<td>$-150</td>
<td>$-150</td>
<td>$-500</td>
</tr>
<tr>
<td>Gross revenue</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>State share</td>
<td>$-350</td>
<td>$-350</td>
<td>$-350</td>
</tr>
<tr>
<td>Royalty</td>
<td>$-</td>
<td>$-350</td>
<td>$-</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$650</td>
<td>$650</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income tax</td>
<td>$-150</td>
<td>$-150</td>
<td>$-500</td>
</tr>
<tr>
<td>Earnings</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
</tr>
</tbody>
</table>

* For the sake of simplicity, the examples are shown unleveraged.
In each jurisdiction, the total government take is the same, yet in Countries A and B the cap on potential interest deductions is linked to a much lower EBITDA. Assuming a 20% cap, not more than $130 of interest would be deductible. In the case of Country A, this arises because the company does not obtain title to hydrocarbons until after the state's share has been allocated; thus, it will not reflect the gross revenue in its financial statements. In the case of Country B, a significant proportion of the government's take is linked to gross production and, therefore, deducted “above the line.” The effect is the same as the position in Country A: EBITDA is reduced as a significant part of the government take has already been deducted. Only projects in Country C are able to benefit from an interest cap that has not been depleted by a significant element of government take. In this case, a 20% cap gives a maximum deductible interest expense of $200 as compared to only $130 in Countries A and B.

Groups that are required to separate components of their operations (exploration, production, transportation, trading, refining, etc.) for commercial and legal reasons will also be affected. Even within a domestic context, this separation could create distortions in the calculation of an EBITDA-linked interest cap, particularly if the implementing jurisdiction does not permit consolidation of different legal entities for purposes of computing the cap.

It also should be noted that the group ratio test may not provide effective relief for some oil and gas groups because many upstream companies are not heavily debt leveraged but rather utilize equity. Intragroup financing arrangements, whilst justifiable in the past, might therefore no longer be tax-efficient.

There may, however, be some potential benefits for upstream companies in using an EBITDA-linked cap. Depletion, depreciation and amortization are significant expenses for upstream companies, given the capital-intensive nature of the industry. So taking earnings before these items as the basis for the interest limitation is helpful. This may be especially true for companies with mature producing portfolios, which may give them a competitive advantage over exploration-oriented companies.

Overall, it seems that these new measures will favor short-term projects with rapid pay-back as compared to long-term projects. Given the complexities of international oil and gas companies, one can see competitive advantages being created and lost by companies within the oil and gas industry as a result of the new rules.

**Recommended actions**

The OECD recommendations on action 4 do not, by themselves, have direct effect. A key priority for international oil and gas groups is to monitor the implementation of new rules in the territories in which they operate. It would be worthwhile to perform some sensitivity analysis, e.g. using current and forecast financial information to compare net interest expense with EBITDA in the various jurisdictions in which a group operates to identify territories where there is a likelihood of a tax impact if action 4 recommendations, or other changes intended to have a similar impact, are implemented. In the event there are clear exposures, groups should assess whether remedial action could be taken quickly and easily, if required. In general terms, transactions to “push down” debt into existing international operations may not be straightforward and any refinancing may take time to implement given issues such as exchange control approval. Being ready to change should the need arise is of critical importance.

In addition, action 4 should not be viewed in isolation. Any consideration of changes in financing structures to address the implementation of the action 4 recommendations also must consider the implications of, and interaction with, the other BEPS recommendations and how these might be implemented. For example, actions 2 (Hybrids), 3 (CFCs), 5 (Harmful tax practices) and 6 (Prevent treaty abuse) all should be considered when a group is reviewing financing structures. Actions 8, 9 and 10 consider various aspects of transfer pricing, which also need to be considered when reviewing financing arrangements within multinational groups.
Financing Mexican energy reform

Carl Koller and Victor Ramos, Deloitte Mexico

Background
Constitutional amendments and legislation introduced in 2013 and 2014 heralded a seismic shift in Mexico’s energy sector – the state oil monopoly ended and the sector was opened up to private, foreign and local investors for the first time since 1938. This was followed by legislation that outlines the steps needed to transition opportunities to reality. The government hopes that the nation’s vast natural resources may be better exploited due to the expertise and financial strength of private investment. Financing plays a key role due to the magnitude of investment required, current oil prices and the resulting reduced cash flows for traditional investors in oil and gas projects.

One mechanism introduced to encourage investment in energy infrastructure is the use of specific vehicles accompanied by appropriate tax provisions, in particular, the new Investment Trusts in Energy and Infrastructure (FIBRA E).

The FIBRA E structure enables a sponsor, which already holds shares in a mature operating company, to place the shares of that operating company in a trust – the FIBRA E trust – that issues “securitized trust certificates for investment in energy and infrastructure” (CFBs). The aim of the FIBRA E is to allow owners of mature assets generating stable cash flows to monetize them in a tax-efficient way so that capital raised can be invested in new projects.

The pass-through tax scheme of the FIBRA E enables the income from the operating company to be attributed proportionately, not only to the holders of the CFBs, but also to other stockholders independent from the trust.

The following summarizes the most important issues relating to the FIBRA E investment vehicle and the tax treatment of a FIBRA E.

A dedicated investment vehicle
The 2016 budget presented by Mexican President Enrique Peña Nieto proposed changes in legislation concerning investment vehicles. This included the creation of the FIBRA E, through tax rules issued by the tax authorities in September 2015. The main objective of the FIBRA E is to capture, in an effective manner, important flows of domestic and foreign investment in certain energy and infrastructure projects.

Notable deficiencies in the design of the FIBRA E rules, promptly picked up by the financial community and tax advisers, led to the issuance of revised rules in April 2016.

The FIBRA E regime creates an equity financing vehicle inspired by the US Master Limited Partnership (MLP). A major consideration is that operating companies are considered pass-through entities for tax purposes (i.e. the tax is paid at the level of each investor). The expectation is that, for a number of investors, this vehicle will reduce the effective tax rate on their investment as, for example, there will not be a 10% withholding on dividends paid to individuals or foreign investors.

Eligible projects
Below we outline the activities that can be performed by operating companies to be owned using FIBRA E structures, within the hydrocarbons, electricity and infrastructure sectors. The operating companies must perform the activities on an “exclusive” basis, which means that 90% or more of their taxable income per year must come from such activities.

Qualifying activities are as follows:

• Oil and gas activities (except exploration and production activities), as well as commercialization and public retail, but including:
  – Petroleum – treatment, refining, transportation and storage.
  – Natural gas – processing, compression, liquefaction, decompression and regasification, as well as transportation, storage, distribution, treatment, mixing and conversion.
  – Petroleum products – transportation, storage, distribution, treatment, mixing, processing and conversion.
  – Petrochemicals – pipeline transportation and storage linked to pipelines, treatment, mixing, processing and conversion.
  – Hydrocarbons – transportation, storage and distribution.

• Electricity – electricity generation, transmission or distribution activities.
• Other infrastructure projects, subject to concessions or contractual arrangements between the public sector and private parties, with a remaining term of seven years or more:

- Roads, highways, railroad tracks and bridges.
- Urban and intercity transportation systems.
- Ports, marine terminals, and port installations.
- Civil airfields (but not private airfields).
- Core telecommunications networks (projects to increase growth).
- Public security and social re-integration.
- Drinking water, drainage, sewage and treatment of wastewater.

**Pass-through status and other tax benefits on dividends and capital gains**

The operating company whose shares are acquired by a FIBRA E will apply the same pass-through regime as that already provided for by the law for a business activity trust. Accordingly, those operating companies will compute their taxable profit, but will not pay the corresponding tax; rather, the taxable profit will be proportionally allocated to the shareholders. Such distribution to the FIBRA E trust shareholder will imply the indirect distribution to the holders of CFBs. Tax losses of the operating company may be deducted only from the taxable profits of the operating company itself.

As a result of the pass-through regime, the operating companies will not apply the corporate income tax rate (30%) to their taxable profits and will not apply the normal control mechanisms for the corporate distribution of profits and capital reimbursements associated with the net tax profits account and net paid-in-capital account (commonly called CUFIN and CUCA, respectively), which are required for other non-transparent companies: This will enable the free flow of dividends and reimbursements not available to companies paying their tax under the normal regime.

**Capital gains on the sale of operating company shares to FIBRA E**

When the FIBRA E pays consideration for the transfer of the operating company shares to the “Sponsor” (i.e. the owner of the operating companies) with the delivery of CFBs, the sponsor may defer recognizing the gain as taxable income. Fifteen percent of the deferred gains must be accrued annually over six years and 10% in year seven. The deferral terminates when the CFBs are sold, the FIBRA E sells the shares of the operating company or the operating company sells the underlying assets.

In this sense, if a sponsor were to sell (either partially or totally) its CFBs, it will trigger the payment of the deferred tax on the proportion of sold CFBs, whereas by keeping the CFBs they could be used as a collateral on a loan.

**Withholding tax**

Resident individuals holding CFBs will consider their proportionate share of the taxable income distributed to them by a FIBRA E as income generated from business activities. Upon distribution, the FIBRA E must withhold income tax at a rate of 30%, which will represent a provisional tax payment for the individual that may be offset against the taxpayer’s final liability for the period.

The treatment applicable to non-resident individuals and companies is similar to that applicable to resident individuals, although for nonresidents, the tax withheld is considered a final payment. Nonresidents do not have any formal obligations attached to these investments, such as registering in Mexico or filing returns.

Income obtained by Mexican pension funds that invest in a FIBRA E will be tax exempt so withholding tax will not apply. It is not clear whether investments by foreign pension funds also should be exempt.

Individuals or non-resident holders of CFBs will not be subject to the 10% withholding tax on the distribution of dividends.

**Sale of CFBs**

Mexican tax resident individuals and non-residents holding CFBs will be tax exempt on the sale of CFBs, while Mexican tax companies will be subject to the general provisions under the Income Tax Law.

**Key takeaways**

Mexico’s effort to overhaul its investment vehicles comes at a time when a plunge in oil prices and dwindling production hit the Mexican state-owned oil company. The new rules aim to generate a greater flow of private investment into strategic projects generating opportunities to utilize financing at a lower cost. The FIBRA E will allow access for the investing public to projects in the energy and infrastructure sectors. The new vehicle will serve all types of companies (both private and with government participation) with projects or stabilized assets that generate stable cash flows, and be offered to investors in exchange for resources that companies can continue to invest in new projects, while reducing the tax burden of monetizing them.
Iran – A new dawn?

Alex Law and Alan Onslow, Deloitte Middle East

On 16 January 2016, certain international sanctions against Iran were lifted after the country met its obligations under the Joint Comprehensive Plan of Action (JCPOA). For a country with immense hydrocarbon reserves (Iran is estimated to have the world’s largest natural gas reserves and the third largest oil reserves), this has opened up significant investment opportunities in the oil and gas sector.

With such abundant reserves, Iran’s economy, like many in the Gulf region, has been heavily dependent on oil. In the 1990s, Iran introduced buyback contracts designed to encourage foreign investment in the industry, while retaining state ownership of natural resources, a requirement under the country’s constitution. However, the imposition of sanctions – initially by the US and then by the UN – saw Iran’s oil and gas industry become increasingly isolated from the international community.

In preparation for the lifting of sanctions, the National Oil Company of Iran (NIOC) announced that a new model petroleum contract (the Iran Petroleum Contract (IPC)) would be developed to replace the buyback contracts, which were considered by many international oil companies (IOCs) to be unattractive. Under the new IPCs, the NIOC is expected to provide opportunities for investment in the development of 52 oil and gas fields and 18 exploration blocks.

A draft framework for the new IPCs provides an overview of the expected mechanics. Two of the key features of the draft IPCs are as follows:

- The new contracts are designed as “risk service contracts” where the IOC would bear exploration risk but would receive compensation based on a fee per barrel if successful exploration leads to production. Under these contracts, the Iranian state would retain ownership of the oil produced (under production sharing agreements, title to a portion of hydrocarbons passes to the contractor).

- IOCs would be required to contract with the NIOC either through an incorporated or unincorporated joint venture with a local Iranian partner.

Previous petroleum contracts with the NIOC generally included provisions entitling the IOC to recover taxes incurred under the contract. Based on a draft of the IPC, it appears that these would operate in a similar manner, allowing an IOC to recover Iranian levies, charges, fees and taxes in respect of the performance of the contract, through a cost recovery mechanism. Employment taxes, social security charges and taxes relating to subcontractors, etc., however, would not be recoverable.

Accordingly, if the IPC is implemented as currently drafted, an IOC should be able to recover corporate tax costs but still would be liable to employment taxes at rates of up to 25% and Social Security for employees (currently, 23% for the employer and 7% for the employee), in addition to having the obligation to withhold tax on certain payments to subcontractors.

It should be noted that discussions about the fiscal regime are ongoing and there may be substantial changes before it is finalized.

Our view is that while the lifting of sanctions provides a clear opportunity for Iran to revise fiscal terms for oil and gas contracts, Iran may not be alone in this endeavor. The precipitous drop in oil prices over the past couple of years has affected many economies within the Middle East and further afield. At a time when there are chronic strains on public revenues, a re-assessment of how countries can maximize their revenue from the hydrocarbon industry, while at the same time encourage investment, may lead to changes to petroleum regimes in Iran and across the rest of the region.

Our view is that while the lifting of sanctions provides a clear opportunity for Iran to revise fiscal terms for oil and gas contracts, Iran may not be alone in this endeavor.
Nigeria’s Petroleum Industry Bill (PIB) originally was conceived in 2008 as a comprehensive legislative framework to achieve a fundamental reform of the oil and gas industry in the country. The PIB was intended to consolidate all existing petroleum laws (about 16 laws, including tax laws), introduce new provisions and update the regulations governing the industry in keeping with changes in the global oil and gas sector. Given the ambitious scope of the bill, the PIB became immensely complicated and created regulatory and fiscal issues that could not be agreed amongst stakeholders. Attempts to reach consensus resulted in several versions of the bill, and it became difficult to determine which version was the authentic text under consideration by the National Assembly (NASS). Ultimately, neither the 6th nor the 7th NASS succeeded in passing the PIB into law.

The fiscal proposals in the PIB were particularly complex and controversial, and they included a proposal to abolish the petroleum profits tax (PPT) and instead subject upstream companies to company income tax at a rate of 30%, as well as a new tax, known as the Nigerian Hydrocarbon Tax, to be levied at rates of 25% or 50%, depending on the location of the relevant production.

Despite the failed attempts to pass the PIB, the need to overhaul, restructure and streamline Nigeria’s oil and gas industry for regulatory, operational and fiscal efficiency remains a key priority for the administration of President Buhari. The PIB was repackaged to address regulatory and governance issues, but not fiscal matters, with the revised version now entitled the “Petroleum Industry Governance and Institutional Framework Bill” (PIGIFB), which was submitted to the National Assembly in December 2015.

The full title to the PIGIFB describes it as, “An Act to Provide for the Governance and Institutional Framework for the Petroleum Industry and Other Related Matters.”

The stated aims of the PIGIFB are:

• Create efficient and effective governing institutions, with clear and separate roles;

• Establish a framework for the creation of commercially oriented and profit-driven petroleum entities that ensure value addition and internationalization of the Nigerian petroleum industry;

• Promote transparency and accountability in the administration of petroleum resources; and

• Create an encouraging business environment for the petroleum industry.

PIGIFB has 91 sections organized into six parts as follows:

• Part I: Objectives (as noted above);

• Part II: Proposed functions and powers of the Minister of Petroleum Resources, including rights of pre-emption;

• Part III: Establishment of the Nigeria Petroleum Regulatory Commission to serve as the sole regulatory institution for the oil and gas sector;

• Part IV: Establishment of two commercial entities (Nigeria Petroleum Assets Management Company and Nigeria National Petroleum) and their shareholding and board structures and business objectives;

The National Assembly is the bicameral legislative arm of the Nigerian government. The lower chamber is the House of Representatives and the upper chamber the Senate.
Part V: Various matters in respect of Nigeria National Petroleum, which would be an integrated oil and gas company operating as a fully commercial entity across the entire value chain; and

Part VI: Repeal, transition and savings provisions, including a proposal to grandfather licenses, certificates, permits and contracts issued by the Department of Petroleum Resources and Petroleum Products Pricing Regulatory Authority that were in effect before the commencement of the PIGIFB.

The provisions of the PIGIFB have raised the following concerns in relation to taxation, which the NASS will consider as the bill moves through the legislative processes:

(i) Section 6(2)(b) empowers the Commission to conduct audits of the activities of upstream operators and service companies to ensure compliance with Nigerian laws, potentially including the tax laws. This would conflict with the role of other regulators, including the Federal Inland Revenue Service (FIRS). It is unclear whether and what right of appeal would be possible against decisions of the Commission.

(ii) Section 6(2)(l) requires the Commission to “liaise with the Federal Inland Revenue Service on cost deductions.” The purpose of this provision is not clear, and it is troubling that the PIGIFB includes an override of other legislation, including the Petroleum Profits Tax Act (PPTA). Since the issue of cost deductions for PPT purposes is governed by the PPTA, it is not clear why the Commission would be required to liaise with the FIRS regarding cost deductions.

(iii) Section 6(7) provides that “notwithstanding the provisions of any other law or regulation, no government agency shall exercise any powers and functions in relation to the petroleum industry in conflict with the powers and functions of the Commission, except for environmental matters where the Federal Ministry of Environment shall have overriding authority.” It is concerning that the overriding authority of FIRS in relation to tax matters is not mentioned in this section.

(iv) Section 7 (g) empowers the Commission to “enforce the provisions of any enactments or regulations applicable to petroleum operations,” which creates a further risk of conflict with FIRS and other bodies.

Although the PIGIFB passed its second reading in the NASS on 27 April, 2016, it is hoped that NASS members consider lessons from the history of the PIB to ensure that the bill delivers the expected solutions and does not become a trigger for fresh conflicts. The expectation is that once the PGFIB is passed, a separate bill covering fiscal matters will be submitted to the NASS, though no draft is available at the time of writing. A further update will be provided as soon as this becomes available.
Introduction
In his latest Budget (March 2016) following continued constructive engagement with the industry, the Chancellor of the Exchequer, George Osborne, announced a number of oil and gas tax changes at a time when the industry has been adjusting its expectations that oil and gas prices will be lower for a longer period of time. These changes have been seen as positive and in reality, a necessity to secure the long-term future of the UK Continental Shelf (UKCS).

This fiscal reform, coupled with several non-fiscal announcements made by the UK Prime Minister, David Cameron, earlier in 2016, demonstrate that the UK government recognizes the need for significant change to protect the hundreds of thousands of jobs the industry supports, and is willing to deliver the necessary policy decisions. Perhaps given the impact which the decline in the UK steel industry has had over the past 12 months, the government has been encouraged to play an active role in maintaining North Sea activity and investment. Combined, these changes are expected to be worth approximately GBP 1 billion to the industry over the next five years.

Headline rate changes
Businesses that carry out oil and gas exploration and extraction activities in the UK and its continental shelf are subject to several layers of tax. Petroleum Revenue Tax (PRT) is applied at the field level (for older fields only), with ring fence corporation tax and the supplementary charge (a secondary tax akin to corporation tax) levied at the company level. The most notable Budget announcement related to PRT is the immediate and permanent reduction in the rate of PRT from 35% to nil, effectively abolishing the tax. Although only around 40 fields have paid PRT over the life of the UK basin, this announcement will improve the late-life economics of a number of key fields, helping to prolong economic production and deferring decommissioning. Some of these fields are of particular importance because they function as hubs, providing an export route for known and yet to find accumulations. Combined with the announcements on the expansion of the investment allowance (an allowance against the supplementary charge, which is linked to capital expenditure) and encouragement for companies to apply under the UK guarantees scheme (under which an unconditional and irrevocable financial guarantee of scheduled principal and interest is provided by the UK government in favor of a lender to a UK infrastructure project), this speaks to government’s specific commitment to the future of critical North Sea infrastructure.

Readers who have been following the UK oil and gas regime will be aware that this has not been the only change to headline oil and gas tax rates. The supplementary charge was reduced by a combined amount of 12% in late 2014 and early 2015. The Chancellor went further in Budget 2016, announcing an additional 10% cut, bringing the rate to 10% as from 1 January 2016.

Taking into account this cut and the zero rating of PRT, the headline marginal rates for exploration and extraction activities in the UK now are 40%, as opposed to the 62% (non-PRT fields) to 81% (PRT fields) that applied in 2014, immediately before the fall in oil and gas prices.

It was interesting that the supplementary charge, rather than ring fence corporation tax, was reduced, as this has meant that the impact of the investment and cluster area allowances relative to companies’ overall tax bills has been diluted, but the hope will be that a more attractive headline rate will encourage additional capital investment from global oil and gas players at a time when the UK is having to compete harder than ever for its share.
Other changes
In addition to the changes in the headline rate, the government confirmed that the investment and cluster area allowances will be extended to allow tariffing operations to activate accumulated allowances, making the measures more effective for infrastructure primarily maintained for the benefit of third parties. This feature of the investment allowance has been an ambition of government since the allowance was introduced in 2015. The key discussion point remains the transparency of infrastructure access agreements and the allocation of the benefit of the allowance between users and owners. This area will need to be worked through before the introduction of the secondary legislation and is expected to be a continued area of dispute between infrastructure owners and new entrant exploration and production companies.

Exploration
Following the successful completion of the government-funded program of seismic and other geoscientific surveys in 2015, the Budget confirmed the availability of GBP 20 million for a second program of surveys to encourage exploration in under-explored areas of the UKCS. This funding was announced in January 2016.

The funding will again be allocated to the Department of Energy and Climate Change and the Oil and Gas Authority (OGA) to commission. It is expected that the program will take place in Summer-Autumn 2016. The Budget document costed this measure at GBP 15 million, potentially reflecting the fact that the first program was delivered under budget.

Decommissioning
It is crucial that the companies that are best placed to operate assets in the most efficient way possible are given the opportunity to obtain these assets as the UKCS enters the next phase of its life. Until now, companies have been reluctant to sell their oil and gas assets unencumbered with the associated decommissioning liabilities as there has been a lack of clarity over the availability of decommissioning tax relief on their spend (there was uncertainty whether companies no longer on the applicable licence could claim deductions for decommissioning spend under existing legislation). Consequently, companies with the potential to innovate alternative approaches have not been able to acquire appropriate assets.

Alongside the Budget, the UK authorities confirmed that companies will be able to access tax relief on expenditure in respect of decommissioning liabilities that are retained even after the asset is sold. This welcome clarification should facilitate transactions where the decommissioning liability and the uncertainty over the associated tax relief has been a blocker, encouraging new entrants for late-life assets and the development of alternative late-life business models. In addition, the government stated that it is willing to consult on improving the regime for tax relief on decommissioning to encourage the transfer of late-life assets, provided the overall cost of decommissioning is reduced, an area where the industry and OGA both will play a role.

Other areas of interest
The following areas also are relevant for the oil and gas sector following Budget 2016:

• Loss relief – The government announced a restriction on the amount of brought forward losses that could be used to offset current year profits, as well as additional flexibility over how tax losses can be utilized. From 1 April 2017, the use of brought forward losses will be capped at 50% of the profit in that year for companies subject to mainstream corporation tax. This change will not apply to oil and gas ring fence trades.

• Interest – The Treasury announced its response to BEPS action 4, introducing a restriction on the deductibility of corporate interest expense from 1 April 2017. However, the government has stated that it will consult to ensure that existing commercial arrangements within the ring fence are not adversely affected.

These carve-outs are important for the industry given the differential tax regime, cash-flow constraints and commercial funding structures of the oil and gas industry relative to companies subject to “normal” levels of corporation tax. The carve outs illustrate that the government understands the current challenging conditions the basin faces and has listened to critical representation.

Conclusion
The UK government has sought to remain globally competitive in the face of the precipitous decline in oil and gas prices by making significant changes to the fiscal regime. Arguably, a “reset” of the regime was overdue in light of the continued maturation of the UK basin and operational challenges to the assets themselves, but the changes nonetheless have been welcomed.
State approves concept of new tax and customs legislation

The Kazakhstan government is working on the development of a joint Tax and Customs Code (New Code). According to the recently approved Concept of the New Code (Concept), which was signed off by the government in April 2016, the principal underlying objective of the New Code is “achieving improvements in tax policy.” Specifically outlined target areas include the taxation of the extractive industries and collection of indirect tax, improvement of administration of state revenue, and increasing the effectiveness and transparency of the tax and customs administration.

Amongst the measures aimed at improvements to the taxation of the extractive industries, the Concept highlights:

- The introduction of detailed guidance regarding ring fence tax accounting (which operates on a contract-by-contract basis);
- The elimination of commercial discovery bonuses (with an accompanying increase in the rates of mineral extraction tax to maintain the current overall tax burden); and
- Separation of the tax regime for upstream oil and gas from the regime that applies to mining companies.

Whilst the reforms proposed may be seen as progressive, industry reaction has been muted and the general consensus is that more far-reaching reform is needed to attract substantial new investment.

Much has been written in recent months about Kazakhstan’s proposed reform of indirect taxes. The stated objective of this initiative is to improve the effectiveness of indirect tax assessment and collection and to combat VAT fraud. The current VAT regime is proposed to be replaced by a sales tax that would be levied at each level of the supply chain at a rate not exceeding 5% of turnover. There would be an exemption for export sales.

The purchaser of goods and services would act as a “tax agent” and withhold the sales tax upon payment to its suppliers. This component of the overall reform project has been subject to intense debate and, as at the date of publishing, no final decision appears to have been taken by the government.

While no draft legislation has been issued on the overall tax and customs reform, the intention is that the New Code will be fully approved by the government and submitted to parliament by the end of summer 2016, with new rules becoming effective on 1 January 2017.

Level of Customs Duty on Exports of Crude Oil linked with market prices

In response to the sharp decline in global oil prices over the past two years and the associated stresses placed on local producers, in February 2016 the Kazakhstan government passed an order that lists goods subject to Customs Duties on Exports of Crude Oil (ECD), the applicable duty rates and the period for which such rates will apply.

The order also sets out a revised basis for the calculation of ECD on crude oil (and goods manufactured from oil). In line with this new calculation methodology, the government has adopted a formula that links the rates of ECD to market oil prices. The formula calculates the weighted average of daily market oil prices based on Urals (Mediterranean) and Brent quotations. Depending on the average oil price derived from this calculation, the mechanism provides a scale to determine the applicable ECD rate. The scale sets the ECD rate at USD 0 if the average oil market price is USD 25 per barrel or less. As prices rise above USD 25 per barrel, the rate increases. According to the new scale, the upper limit for ECD is set at USD 236 per ton if the average oil price exceeds USD 185 per barrel.

For purposes of ECD calculations, the average oil market price will be calculated by the tax authorities and published on the official website of the State Revenue Committee. For example, according to the official website, the average market price for crude oil for the purposes of determining ECD obligations in April 2016 was USD 36 per barrel; therefore, the applicable ECD rate in April is set at USD 35 per ton of oil exported.
ECD was introduced in 2008 and initially it was determined based on a scale of rates linked to market prices. Due to oil price volatility during 2008, the ECD rate fluctuated from USD 110 to USD 204 per ton. The government reduced the rate to USD 0 in 2009 to support exporters. As oil prices started to rise, the government increased the ECD rate. From July 2010 to March 2014, the rate was increased from USD 20 to USD 80 per ton. The rate of USD 80 was in effect until March 2015, after which a decision was made to cut it by 25%. The USD 60 per ton rate remained effective until January 2016. Pending the introduction of the comprehensive new rules for calculating ECD on crude oil, the ECD rate had been set at a provisional level of USD 40 per ton from January 2016.

### Scale of ECD rates (2016)

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<th>Average oil market price for preceding period</th>
<th>ECD rate, USD per tonne</th>
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<tr>
<td>From $185 per barrel</td>
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May 2016 saw an important development in the long-running debate between taxpayers and the Tanzania Revenue Authority (TRA) over the application of withholding tax on payments for services.

For many years, the TRA has taken the position that payments made by Tanzanian businesses for services are Tanzanian-source income regardless of where the services are provided – the TRA has tended to focus on the place where the results of the services are used, or the location of the projects to which the services relate. Based on this argument, service payments are subject to a 15% withholding tax under domestic law. Many taxpayers have challenged this position because the definition of Tanzanian-source income in the Income Tax Act refers only to services provided in Tanzania. A number of cases have been brought before the tax appeals bodies.

Whilst several cases have been before the courts for some years, a higher court had not ruled on the issue until recently when the Court of Appeal released its decision in the PanAfrican Energy Tanzania Limited case. PanAfrican is an upstream company producing gas in Tanzania. The company made payments to various consultants for technical services performed outside Tanzania and did not withhold tax.

The TRA attempted to recover the tax it considered due, and the taxpayer appealed the case to the Tax Revenue Appeals Board, which upheld the position of the TRA. Upon a further appeal to the Tax Revenue Appeals Tribunal, the taxpayer prevailed. The case then was heard by the Court of Appeal following an appeal by the TRA. The Court of Appeal is the highest appellate body in Tanzania and its decision amounts to a definitive statement on the interpretation of the law.

According to the Court of Appeal, the statutory language is clear and straightforward: payments for services rendered outside Tanzania are not Tanzanian-source income and, therefore, are not subject to withholding tax. It should be noted, however, that the court recommended that the government consider amending the Income Tax Act, “to remove leeway for loss on (sic) income to the government as it will be found appropriate.” An amendment to the provision has been included in the 2016 Finance Bill presented to the legislature in June 2016. This will come into force on 1 July 2016.
Talk to us

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

**Oil & Gas Tax Leaders**

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

**Chris Roberge**  
Oil & Gas Tax Leader | Global Partner, Deloitte China  
Tel: +852 2852 5627  
Email: chrisroberge@deloitte.com

**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

**Peter Letal**  
Partner | Deloitte Canada  
Tel: +1 403 267 1818  
Email: pletal@deloitte.ca

**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

**Hong Peir Toh**  
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

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

**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
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