Attachment E:

Note on Selected Treaty Issues in Relation to Extractive Industries[1]

Executive Summary

The extractive industries play a crucial role in the process of sourcing natural resources, which are critical for the development of any economy. Both developing and developed countries are crucial actors in the process of natural resource extraction – both as host countries to the extractive activities and also as countries where the extractive industry companies have their head-offices, raise the capital and make crucial strategic decisions.

The activities related to extractive activities present potential opportunities as well as risks to all stakeholders. Since these activities often include a cross-border element undertaken by the foreign investors, licence holders, foreign service providers and suppliers as well as subsequent export of natural resources a number of international tax issues arise.

Some of these issues may be regulated by the provisions of double tax treaties. This note reviews the potential tax treaty issues arising from the extractive industry activities and seeks to consider from the perspective of the UN Model Tax Convention, while reference is also provided to the OECD Model Tax Convention and examples are provided to specific treaties, which may depart from both tax treaty models.

While a significant body of literature exists in respect of the specific domestic law design of extractive taxation, little has been written on the subject of international tax issues related to extractive industry.

This note identifies the industry specific issues in the context of international taxation and reviews the relevant articles of comprehensive tax treaties designed on the basis of the UN and OECD Models.

The note provides an overview of the lifecycle in the extractive industry and also what the key tax treaty issues arising in the process of extractive activities are. The identified issues fall in the following categories:

[1] This draft has been prepared by Tomas Balco with valuable contributions from Jan de Goede, Nana A. Okoh and Susana Bokobo Moiche as well as the UN Secretariat and other members of Subcommittee on Extractive Industries Taxation Issues for Developing Countries.

- Personal Scope – addresses the issue of whether the tax treaty is applicable to the investors – especially in cases where the investments take place through a non-incorporated consortium of several companies/investors;
- Material Scope - addresses the issue of whether the different types of taxes levied in relation to the extractive activities are covered by the tax treaties;
- Territorial Scope – addresses the issue of whether the activities that are taking place off-shore, i.e. in the territorial waters or in the exclusive economic zone are covered by the relevant tax treaty and whether the country to which those areas appertain exercises taxing rights in such areas;
- Existence of Permanent Establishment and Attribution of Profits – addresses the issue of whether as a result of the different activities related to the extractive investment and project, the conditions for the existence of a permanent establishment are met and what the profits are, which the country of source may tax as a result of these activities;
- Transfer Pricing – addresses the issues of potential mispricing of the natural resources as well as equipment and services provided within the framework of extractive projects as well as the measures countries take to manage these risks;
- Sale of Interests in Extractive Projects – addressing issues related to cross-border sale of licences to extractive projects or shares in companies possessing such licences.

The note also covers issues related to the taxation of extractive and export activities, as well as the taxation of individuals involved in extractive activities and aspects of elimination of double taxation.

In addition to these areas unique to the extractive industries, the note also addresses the aspects of financing of extractive projects and aspects relevant to the protection of the tax base, including usage of hedging instruments and abusive practices thereof.

Purpose of this Note

This note was drafted by members of the Subcommittee for Extractive Industry Taxation with the objective to highlight the tax treaty aspects arising in the extractive industry and to provide the Committee with an impression of the various tax treaty issues to enable it to decide on continuing to draft more detailed notes on the various issues raised, so as to fill the current vacuum and provide practical policy and administrative guidance in respect of these issues.

This note is intended to provide an outline of selected tax treaty issues in relation to extractive industries and activities. The objective of this note is to review the tax treaty articles, which are potentially affected and also to highlight the issues that countries, especially developing countries, may wish to take into consideration in the process of designing their tax treaty policy and (re-)negotiating their existing tax treaties as well as application of tax treaties.

The issues raised in this note affect both the tax revenue of the jurisdictions involved and the tax position of companies involved in the extractive activities.

Status of this Note

This note is for guidance only. It is intended to address the issues in brief form and to help build awareness of them, as well as to help put those faced with these issues in a position to make policy and administration decisions in relation to them

Some of the important areas related to the application of tax treaties – for example taxation of capital gains – are to be further elaborated in a separate note. Similarly, a note has been drafted to address the issues of decommissioning.

Terms used

DTC or DTT – Double Tax Convention or Double Tax Treaty
UN Model - United Nations Model Double Taxation Convention between Developed and Developing Countries (2011)[2]
OECD Model - OECD Model Tax Convention on Income and on Capital (2010)
Commentaries – Commentaries to the UN Model and OECD Model Tax Conventions
Consortium – joint venture arrangement of several investors, who may pool the capital and expertise to jointly exploit and share the risks connected to exploiting a particular extractive project.
Licence holder – person(s) who obtain the licence to extract the natural resource from the state, often through a process of competitive bidding.
Operator – entity in charge of performing the actual extraction of the natural resource. Can be the same person as the licence holder, or it can be one of the licence holders, if the licence was granted to a consortium
PE – Permanent Establishment
PSA – Production Sharing Agreement
Royalty – in the context of extractive industry activities, the term "royalty" also refers to the obligatory payment made by the operator of the extraction project to the state as a compensation of the extraction rights. The payment is often calculated with reference to the type, quantity, quality and/or value of the extracted mineral resource. The traditional meaning of the term "royalty" as defined in Article 12 of the UN Model will also be relevant in the context of the extractive industry.
Service Provider – company or individuals providing various types of services in the framework of the extractive industries. May also be referred to as **Subcontractor.**
Supplier – company or individual providing other supplies than services – e.g. supply of equipment, goods and materials.
Treaty Shopping – The practice of structuring an investment/business activity in such a way that a special purpose entity is established in a jurisdiction, which can provide for more favourable tax treaty. The practice may also extend to taking advantage of agreements for protection of investment.
WHT – Withholding Tax

[2] Available at http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

Introduction

Bilateral tax treaties, which usually follow closely the UN or OECD Model Tax Conventions (MTCs), play an important role in coordinating the rules of cross-border tax treatment with the objective to eliminate obstacles to cross-border trade and investment represented especially by double taxation. They (the treaties) do so partially through the allocation of taxing rights to one of the contracting states, while on the other hand potentially limiting the other contracting state in exercise of its taxing rights. This limitation of taxing rights is, with the exception of income from government services (Article 19), affecting only the country of source. The limitations may be either of absolute nature – the tax treaty allocates exclusive taxing right to the country of residence – country of recipient of income (e.g. Article 7, 12 (OECD), 14 (UN)[3]) or of relative nature – the tax treaty limits the country of source taxation through a maximum applicable rate of tax (e.g. Articles 10, 11 and 12 (UN Model).

The limitations of taxing rights placed by the tax treaties on the country of source have thus the potential to limit the ability of the country of source to collect the tax revenue of income earned/sourced with the jurisdiction. The country of source may thus loose the taxing rights completely or the tax rate it may levy on an item of income or property may be limited. The potential issues arising from the above may be emphasized by the abusive practices – the tax treaties can be abused (e.g. treaty shopping, see also the OECD/G20 BEPS project for anti-abuse measures).

In needs to be stressed here that tax treaties always operate in close relation with domestic law. The tax treaties play an important coordination role between the tax systems of two[4] contracting states. The domestic law establishes and determines the issues relevant for the existence of the tax liability, while the tax treaty may suppress this tax liability (fully or partially) or may safeguard this tax liability. With certain exceptions[5], the general view is that tax treaties do not create a tax liability. Therefore, where the domestic law fails to establish a tax liability, the tax treaty will not remedy this situation.

The tax treaties also provide solutions to eliminate double taxation, which reduces the risk of excessive tax costs on cross-border investment. This is achieved either through allocation of exclusive taxing rights – mentioned above, or through the elimination of double taxation in the country of residence (credit or exemption method) – in cases where the tax treaty permits the country of source to levy the tax. The tax treaties thus have the potential of reducing the overall tax burden on investment, the income from investments or activities related thereto.

Tax treaties also provide measures to assure administrative cooperation through:

- elimination of double taxation through mutual agreement procedure (Article 25)
- exchange of information (Article 26) and

[3] In case the threshold established by the tax treaty is not exceeded (Article 7 – threshold in form of Permanent Establishment, Article 14 UN – threshold in form of fixed base)

[4] In rare instances, the tax treaties may have multilateral character – e.g. the Nordic Tax Treaty concluded between five Nordic countries (Norway, Iceland, Sweden, Denmark and Finland)

[5] Some countries – e.g. France and Australia follow the practice that the tax treaties may establish a tax liability.

- in the case of some, usually more recent, treaties in the assistance in collection of taxes (Article 27).

As of the present date, both the UN MTC (2011) and the OECD MTC (2010) contain only very few specific provisions that would address the issues arising in the extractive industries, therefore only the general rules contained in the tax treaty regulate whatever specific issues and situations may arise in extractive industry activities. Due to the special nature of the extraction of natural resources, several countries include specific provisions regarding extractive industries in tax treaties to secure source taxing rights. One common example is a specific "Offshore Activities Article".

Example: Article 21 - Denmark – Latvia (1993) Income and Capital Tax Treaty

Activities in connection with preliminary surveys, exploration or extraction of hydrocarbons

1. Notwithstanding the provisions of Article 5 and Article 14, a person who is a resident of one of the Contracting States and carries on activities in connection with preliminary surveys, exploration or extraction of hydrocarbons situated in the other Contracting State shall be deemed to be carrying on in respect of those activities a business in that other Contracting State through a permanent establishment or fixed base situated therein.

2. Notwithstanding the provisions of paragraph 1, drilling rig activities carried on offshore shall constitute a permanent establishment only if the activities are carried on for a period or periods exceeding 365 days in aggregate in any 18-month period. However, for the purpose of this paragraph, activities carried on by an enterprise associated with another enterprise within the meaning of Article 9 shall be regarded as carried on by the enterprise to which it is associated if the activities in question are substantially the same as those carried on by the last-mentioned enterprise.

3. Notwithstanding the provisions of paragraph 1, profits derived by a resident of a Contracting State from the transportation by ship or aircraft of supplies or personnel to a location where offshore activities in connection with preliminary surveys, exploration or extraction of hydrocarbons are being carried on in the other Contracting State or from the operation of tugboats and similar vessels in connection with such activities, shall be taxable only in the first-mentioned State.

4. Salaries, wages and other similar remuneration derived by an individual who is a resident of a Contracting State in respect of labour or personal services rendered aboard a ship or aircraft covered by paragraph 3 shall be taxed in accordance with paragraph 3 of Article 15.

5. Notwithstanding the provisions of Article 13, a capital gain on drilling rigs used for activities mentioned in paragraph 2 which is deemed to be derived by a resident of a Contracting State when the rig activities cease to be subject to tax in the other Contracting State shall be exempt from tax in that other State. For the purpose of this paragraph, the term "capital gain" means the amount by which the market value at the moment of transfer exceeds the residual value at that moment, as increased by any depreciation taken.

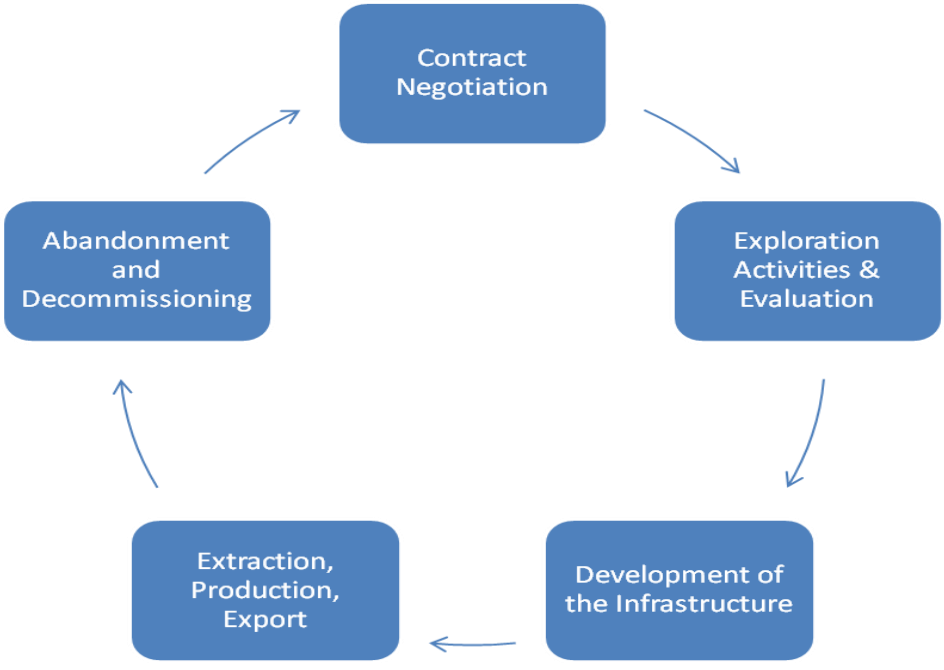
Countries, which do not take special care in the design of domestic law and negotiating their tax treaties and fail to take the considerations of the extractive industries into consideration may potentially loose the taxing rights in respect of income and capital engaged in the extractive activities taking place within their jurisdiction and thus may fail to obtain the tax revenue, which could be otherwise available.

While designing their domestic tax policy in respect of the extractive industries as well as the relevant aspects of tax treaty policy, it is advisable that countries take into consideration the interests of investors – especially with the view to minimize possible double taxation and the economic consequences thereof, while assuring the tax revenue collection related to the economic activities taking place in their its territory.

Overview of Extractive Industry Life-cycle and the likely cross-border – international tax considerations

Extractive industry activities take place over a long period of time, where different critical activities can be divided into five main stages (Contract Negotiation, Exploration Activities & Evaluation, Development of the Infrastructure, Extraction & Production & Export, Abandonment and Decommissioning). Each of these stages represents specific activities carried out in the process of accessing and extracting the natural resources.

Figure 1: Lifecycle of Extractive Industry Project



Each of these activities presents different aspects in respect of the activities undertaken and also different types of international tax issues arising. In the following table, the key activities are summarized alongside the key domestic and international tax considerations.

Figure 2: Stages, Activities, Actors, Domestic Tax Issues and Potential International Tax Issues

	Key Activities	**Actors**	**Domestic Tax Issues**	**International Tax Issues**
Contract Negotiation and Signature	Extractive companies may engage in competitive bidding or contract negotiation with the assistance of advisers and lawyers	Extractive Company, Consortium members, Advisers, Lawyers, Financiers	Obligatory (tax) payments, such as signature bonus, Payments to advisers and WHT consideration	Are signature bonus payments covered by scope of DTT? Taxation of income to advisors? Is DTT applicable?
Exploration Activities & Evaluation	Exploration activities in different form take place – geological studies, drilling, and seismic tests, sample taking and analyzes, Evaluation of potential for further extraction	Extractive Company, Subcontractors specializing in the exploration activities (on-shore and off-shore), Analysts	Obligatory (tax) payments, such as discovery bonus, Payments to subcontractors and the relevant tax considerations (WHT) Does the country exercise taxing rights over the territorial waters and exclusive economic zone?	Are discovery bonus payments coved by the scope of the DTT? Taxation of income to subcontractors? Existence of permanent establishment? Is the given off-shore area covered by the tax treaty?
Development of the Infrastructure	Development of extractive facility (mining pits, extraction wells) and supportive infrastructure including transportation (roads, railway, pipelines), accommodation and office units	Extractive Company, Subcontractors – Construction, Installation and Drilling Companies	Obligatory (tax) payments, such as development bonus (unusual) Payments to subcontractors and the relevant tax considerations (WHT)	Are development bonus payments covered by scope of DTT? Existence of PE of subcontractors?
Extraction, Production, Export	Extractive activities take place on commercial scale, Resource is processed and/or sold/transported/exported	Extraction Company Subcontractors – processing, transportation, other services	Extraction taxes (royalties, share from PSA, hydrocarbon taxes, corporate income tax, hydrocarbon tax), Export related taxes (excise, export customs duty, export rent taxes and other) Payments to subcontractors and the relevant tax considerations (WHT) Adjustments to prices for natural resources (transfer pricing)	Are extraction type of taxes covered by the scope of the DTT? Existence of PE for subcontractors? Treatment of administrative adjustments of prices for natural resources (transfer pricing)

Abandonment and Decommissioning	Extractive activities are finalized and are replaced by decommissioning activities, clean up of pollution and removal of infrastructure	Extraction Company, Subcontractors specializing in decommissioning and environmental clean up activities	Special allowance or reserve created during the life of the project – considerations with deductibility and subsequent taxation of excess reserve Payments to subcontractors and the relevant tax considerations (WHT)	Is the taxation of the excess reserve in accordance with tax treaty? Existence of PE for subcontractors?

Review of identified issues

The key issues identified in the different stages of the extractive project include especially the following:

- Personal Scope – addresses the issue of whether the tax treaty is applicable to the investors – especially in cases where the investments take place through a non-incorporated consortium of several companies/investors;
- Material Scope - addresses the issue of whether the different types of taxes levied in relation to the extractive activities are covered by the tax treaties;
- Territorial Scope – addresses the issue of whether the activities that are taking place off-shore, i.e. in the territorial waters or in the exclusive economic zone are covered by the relevant tax treaty and whether the country to which those areas appertain exercises taxing rights in such areas;
- Existence of Permanent Establishment and Attribution of Profits – addresses the issue of whether as a result of the different activities related to the extractive investment and project, the conditions for the existence of a permanent establishment are met and what the profits are, which the country of source may tax as a result of these activities;
- Transfer Pricing – addresses the issues of potential mispricing of the natural resources as well as equipment and services provided within the framework of extractive projects as well as the measures countries take to manage these risks;

Sale of Interests in Extractive Projects – addressing issues related to cross-border sale of licences to extractive projects or shares in companies possessing such licences. The note also covers issues related to the taxation of extractives and export activities, as well as taxation of individuals involved in extractive activities and aspects of the elimination of double taxation.

In the following, the issues will be further analyzed with the objective to propose both tax policy and tax administration for developing countries.

<u>Personal Scope – Articles 1 and 4 – Persons Covered and Definition of Residence</u>

Many extractive projects may be organized in the form of incorporated, but also in the form of non-incorporated, joint-ventures (also known as consortia).

The general principle of Article 1 is that tax treaties should apply only in respect of the persons (natural personals as well as legal persons, such as companies) who are residents of one or more of the contracting states. Article 4 subsequently provides the definition of who is a resident of a contracting state, which refers to the domestic law of the contracting states.

In most cases, the incorporated join-venture projects would involve the project being carried out through a separate legal entity, which in most cases is subject to tax in its country of residence, which should not cause special issues in respect of the tax treaty application, with the possible issue of *treaty shopping*, which is addressed below.

Non-incorporated joint ventures may, in particular, give rise to questions related to the application of tax treaties. Non-incorporated joint-ventures will operate not as one single legal entity, but as a contractual relation between several investors, where they jointly carry on the extractive activities

and co-own both the assets and income arising from these activities. Consequently, they are also jointly liable for the costs related to the extraction project and potential liabilities. In such arrangements, there may be one of the partners appointed as operator of the project, who will be responsible for the accounting as well as operational aspects of the project, however, the tax liabilities are to be borne by each member of the consortium individually.

Such arrangements give rise to issues under domestic tax law and tax treaties. At the level of domestic law, issues of tax liability will be critical, i.e. the existence of tax liability of the partners in the consortium in the country of source and also in the country of residence.

Under a tax treaty, the considerations related to this issue will be especially those related to the application of a tax treaty – entitlement of the consortium to benefits arising from tax treaty (e.g. reduced rate of branch profit tax).

In most cases, tax treaties (in the absence of deeming provisions – deeming such a joint venture to be a resident of a contracting state) should only apply in respect of those participants to these joint-ventures who qualify as residents of the contracting states. This may lead to further issues – such as when only some of the participants of the joint-venture arrangements are residents of the contracting states (entitlement to proportionate benefits arising from tax treaties).

Another common issue in the extractive industries is the "improper use" of tax treaties including treaty shopping practices. In this respect, neither the UN MTC nor the OECD MTC provides specific provisions, although the Commentaries to Article 1 explain how improper use of treaties may be combatted.[6]

In the light of the BEPS project[7], it is likely that the Limitation of Benefits clause and/or a general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test) will become one of the recommended solutions to deal with the problem. The UN BEPS Subcommittee is currently monitoring developments on base erosion and profit shifting issues.

It is also advisable that developing countries consider domestic law anti-avoidance measures, which as established in both the UN and OECD Commentaries[8] are acceptable and can be applied alongside with treaty based anti-avoidance measures.

Furthermore, it is recommended that countries establish measures of administrative nature – to reserve the right of tax authorities to pre-screen transactions prior to the application of tax treaties. Such measures work as a natural deterrent from some of the most frequent treaty abuse practices.

Material Scope - Article 2 – Taxes Covered

Many countries have developed special tax regimes regulating the tax and compliance obligations of companies engaged in extractive activities. Different types of taxes exist as a result and the question

[6] Addressed in the Commentary to Article 1 of both the OECD and UN MTCs

[7] BEPS stands for "Base Erosion and Profit Shifting". The BEPS project is a project initiated by the G20, which has given a mandate to the OECD to carry out a study and subsequently propose changes to current tax rules, which aim at making such practices impossible. The BEPS project was launched in 2013 and the UN Committee of Experts is monitoring this project through a special BEPS Subcommittee.

[8] Addressed in the Commentary to both the UN and OECD MTCs

arises, which of these special taxes are covered by the scope of tax treaties (are there particular types of taxes to be classified as taxes on income and capital).

In the following table, the different types of taxes and obligatory payments to Governments levied in relation to extractive industry activities are listed with indication of whether or not these types of taxes are to be covered by the scope of tax treaties.

Figure 3: Types of Taxes Levied at different stages of extractive project and the applicability of tax treaty:

Stages	Type of Taxes and Obligatory Payments to Governments	Typical Characteristic	Covered by Scope of DTT
Contract Negotiation and Signature	Signature Bonus	A payment in the form of % (e.g. 1% of expected value of natural resources) or a fixed amount	Usually not (unless the payment is designed in a way that it can be considered a tax on income credited against the CIT)
Exploration Activities & Evaluation	Exploration Bonus	Similar to Signature Bonus	Usually not
	Rent Payments	Payments for the use of land	Usually not
	Tax Levied on Employees	Income Taxes	Yes (taxpayer-individual)
	Tax Levied on Service Providers	Income Taxes	Yes (taxpayer-subcontractor)
Development of the Infrastructure	Bonuses and Rentals	Same as above	Same as above
	Taxes on Employees and Subcontractors	Same as above	Same as above
	Import Duties and Levies, VAT	Indirect Taxes and Levies	No
Extraction, Production, Export	Royalties	Payment on the volume or Value of Extracted Resource	Usually not
	Bonuses and Rentals	Same as above	Same as above
	Production Sharing payments	% of production paid to state	Usually not, unless designed as a tax on income/ % of profit
	Profit Taxes and Excess Profit Tax	Tax on Income/Profit	Yes
	Export Duties and Export Levies	Tax on Value of Exported Resource	No
Abandonment and Decommissioning	Environmental Fees or Penalties	Fines or Penalties for Pollution	No
	Taxes on Employees and Subcontractors	Same as above	Same as above

If the taxes are not covered by tax treaties, those treaties will not affect domestic law, but conversely, other countries will have no treaty obligation to give a credit or exemption to avoid double taxation, which leads to higher overall tax costs related to the particular investment and commercial activities. This is also the reason why many countries that are the host of extractive activities seek to design their tax systems in a way as to assure that the taxes levied on the extractive activities can be credited in the country of residence of the investor.

Example: Norwegian Special Petroleum Tax

A special petroleum tax is levied on profits from petroleum production and pipeline transportation on the Norwegian Continental Shelf. The special petroleum tax is currently levied at a rate of 50%. The special tax is applied to relevant income in addition to standard 28% income tax, resulting in a 78% marginal tax rate on income subject to petroleum tax. The basis for computing the special petroleum tax is the same as for income subject to ordinary corporate income tax, except that on-shore losses are not deductible from the special petroleum tax and a tax-free allowance, or uplift, is granted at a rate of 7.5% per year. The uplift is computed on the basis of the original capitalized cost of offshore production installations. The uplift may be deducted from taxable income for a period of four years, starting in the year in which the capital expenditure is incurred. Unused uplift may be carried forward indefinitely.

In addition to the careful tax design, the countries also seek to include these taxes into the scope of the tax treaties by including the type of tax into the list of examples in Article 2 paragraph 3.

Example – Article 1 of the Norway - United States Income and Capital Tax Treaty *(as amended through 1980)*

The taxes which are the subject of this Convention are:
....
in the case of Norway, the national and municipal taxes on income (including contributions to the tax equalization fund), and the special tax administered under section 5 of the Act of 13 June 1975, No. 35, relating to the taxation of submarine petroleum resources, as in effect on the date of signature of the Protocol to this Convention, and taxes substantially similar thereto enacted after such date.

Those types of taxes levied on profits – such as corporate income tax, special surcharges on extractive companies, as well as excess profits taxes are likely covered by the scope of Article 2.

On the other hand taxes levied in the form of royalties – equivalent of the purchase price of the natural resource – entitling the extractive company to the ownership of the natural resource and subsequent sale – are not usually considered as taxes on income. Similarly, taxes levied on the export of natural resources, as well as bonus payments for obtaining the right to explore or extract the natural resources are usually not covered by the scope of tax treaties.

Additional issues may arise when the countries use the model of production sharing agreements, whereby a portion of income/extracted resources is to be handed over to the government in form of a tax (in kind or in cash). These types of arrangements may fall within the scope of the tax treaty (depending on the taxable base and whether the character of tax is that of a tax on income or capital). However, they may likely require clarification in the protocol to the treaty or in Article 2(3).

Neither the UN MTC nor the OECD MTC contains special provisions to address this issue. However, country practices tend to indicate that some countries seek to include in the scope of their tax treaties also the taxes levied on the extractive activities (as long as these taxes meet the character of taxes on income or capital) – the best way to deal with it is to address the issue in negotiations and specifically include the tax as a tax covered by the treaty. The importance of determining whether the particular tax is covered by the tax treaty lies in the possible implications:

- Any limitation introduced by the tax treaty on the country of source levying the particular type of tax, and
- The obligation of the country of residence to eliminate the double taxation in respect of the particular type of tax.

In addition, implications may arise for the application of other Articles, which mirror the scope of the tax treaty (Article 25 – Mutual Agreement Procedure, Article 26 – Exchange of Information, Article 27 – Assistance in Collection of Taxes, unless the taxes covered by these articles are extended beyond those established in Article 2).

Territorial Scope - Article 3 – General Definitions

Neither the UN nor OECD MTCs contain specific terms/definitions, which would specifically address the issues of the extractive industries.

However, since many countries, in their practices, include the definition of “Contracting States” in Article 3, this definition determines the geographic scope of the application of the tax treaty.

Such definition may include notions of territory and territorial waters, but also of the continental shelf and exclusive economic zones, within which the states may exercise the taxing rights in accordance with international law.

The question may arise, whether in the case of omission of the extended definition (continental shelf and exclusive economic zone), the taxes levied on the activities taking place within the jurisdiction of the contracting state fall within the scope of the treaty and the country of source is to be potentially limited in the exercise of its taxing rights and country of residence is to be obliged to eliminate the potential double taxation.

Article 5 – Permanent Establishment

The term permanent establishment is an important threshold that is central to Article 7 on taxation of business profits and is defined in Article 5. However, it is also critical for the operation of other articles regulating the taxation of income such as dividends, interest, royalties, capital gains, income from employment as well as other income and capital.

In most cases whether or not there is a permanent establishment determines whether the country of source may levy taxes on the extractive activities or alternatively on income from services being provided by the service providers to the extractive industry operators taking place within the country or income derived from the sources within the country.

For the effective exercise of taxing rights the domestic tax law defining the tax liability of non-residents is also critical, since in absence of the existence of tax liability, the existence of a permanent establishment within the meaning of Article 5 of a DTT will not be sufficient for the country to levy tax on the income derived through such activities.

The question of whether there is a permanent establishment will be especially critical if the investor does not operate through a resident incorporated legal entity, but as a non-resident in the host country. A number of countries may require that for the investor to obtain a licence to explore or extract resources the company must be incorporated with the country. In which case the issue of a permanent establishment may not arise as the primary question, since the investor will carry out with the investment with a local incorporated company, which is likely to qualify as a resident for tax purposes.

In cases where the host country does not prescribe such an obligation it will be critical to analyze whether the presence and nature of activities constitute a permanent establishment.

In this respect, both the UN and OECD MTCs include in the illustrative examples of permanent establishment in paragraph 2 (f) reference to: *a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

This is the only specific provision specifically addressing the extractive industry activities and the illustrative example makes it clear that the extractive activities carried out by non-resident will constitute a permanent establishment in the country of source and thus the income derived and capital owned in respect of operating a mine, oil or gas well as well as any other place of extraction of natural resources by the non-resident enterprise may be subject to tax in the country of source (location of the natural resource).

The permanent establishment may exist not only for the extraction company, but may also arise to the various subcontractors and service providers providing various services as demonstrated below. The existence of the permanent establishment of the service providers will depend on the facts and circumstances and the nature of the services that they provide as well as the definition of permanent establishment (whether the tax treaty will contain special rules addressing a permanent establishment due to carrying out of exploration or other services related to extractive industry, construction activities or the Services PE definition as per Article 5 paragraph 3 letter b) of the UN MTC).

Important considerations will arise from the possible exclusion of certain activities from the permanent establishment definition, due to the nature of the activities, which may fall within the scope of exclusions in Article 5 paragraph 4 of the UN and OECD MTCs. It is thus important to consider, to what extent these exclusions may limit the ability of the hosting country to tax the profits arising from such activities.

Figure 4: Stages in extraction project and the types of permanent establishment

Stages	Key Activities	Potential for Permanent Establishment
Contract Negotiation and Signature	Extractive company may get engaged in competitive bidding or contract negotiation with assistance of advisers and lawyers	Permanent establishment will likely arise for the investors starting at the moment of negotiation and conclusion of contract, while there may be no income yet
Exploration Activities and Evaluation	Exploration activities in different forms take place – geological studies, drilling, and seismic tests, sample taking and analyzes, Evaluation of potential for further extraction	Permanent establishment may arise as a result of exploration activities
Development of the Infrastructure	Development of extractive facilities (mining pits, extraction wells) and supportive infrastructure including transportation (roads, railway, pipelines) as well as accommodation and office units	Permanent establishment may arise a result of construction and installation activities
Extraction, Production and Export	Extractive activities take place on commercial scale, Resource is processed and/or Transported/Exported	Permanent establishment arise in respect of the transportation activities, which are not covered by Article 8
Abandonment and Decommissioning	Extractive activities are seized and are replaced by decommissioning activities, clean up of pollution and removal of infrastructure	Permanent establishment may arise as a result of various decommissioning and clean up activities

Once the permanent establishment will be considered to exist in accordance with Article 5 of DTT (assuming the activities do not fall in the scope of excluded preparatory and auxiliary activities), the country of source will have the right to levy a tax on the income and capital and it is thus the question, whether it will properly exercise the allocated taxing rights to the elements of income or capital based on its domestic law. In absence of domestic law provisions, which would also effectively levy a tax on the income or capital connected with such activities, the tax treaty merely allocates the taxing rights to the country of source, which in absence of domestic law provisions may not exercise these taxing rights.[9]

Subsequently, the country of residence has the obligation to eliminate double taxation in accordance with Article 23 (credit or exemption).

In addition to the wording contained in the UN and OECD MTCs, the OECD Commentary to Article 5 paragraph 2, which is quoted in the UN Commentary, contains a paragraph (15), which suggests different alternative approaches to regulation of the PE threshold in respect of exploration activities:

> *(15) "They (Contracting States) may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:*
>
> *a) shall be deemed not to have a permanent establishment in that other State; or*
>
> *b) shall be deemed to carry on such activities through a permanent establishment in that other State; or*
>
> *c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.*
>
> *The Contracting States may moreover agree to submit the income from such activities to any other rule."*

Other general provisions of Article 5 may be also relevant in respect of the extractive activities:

- Fixed place of business (Article 5, paragraph 1)
    - Under this provision any other activities of the enterprise carrying out extractive or other activities related to natural resource extraction (e.g. processing, refining) may be subject tax in the country of source if carried out through a fixed place of business.
- Construction or Installation project (Article 5 paragraph 3 OECD MTC and Article 5 paragraph 3(a) UN MTC)
    - Under this provision either the extractive company or its subcontractors may constitute a permanent establishment as a result of construction or installation activities. The two conventions differ especially in respect of:

[9] Furthermore, should the country of residence be obliged to apply the exemption method, in absence of a "Subject to tax" clause in Article 23, double non-taxation may arise in such situations.

- The activities covered – the UN MTC also includes the supervisory activities in connection with the construction and installation projects, and
- The duration threshold – under the OECD MTC the permanent establishment would be considered to exist, if the threshold exceeds 12 months and under the UN MTC the PE would be considered to exist if the threshold exceeds 6 months.

Issues may arise in the process of application, whether certain activities will constitute construction activities – such as drilling a well or shaft. In the oil and gas industry, it is commonly understood that the well is being constructed, since it requires beyond the mere drilling activity, significant other construction activities, including concrete works, welding, cementing, etc.

- Services Permanent Establishment (Article 5, paragraph 3b UN MTC)
    - Under this provision, the services provided by non-resident enterprises, including exploration, consulting or other services may constitute a permanent establishment where such activities take place within the country for a period(s) exceeding 6 months in any 12 month period. This provision thus permits the country of source to levy tax on business profits of enterprises, which may not have a fixed place of business in the country of source, however their activities take place within the country in excess of given duration of time. By including the provision of Article 5 paragraph 3, letter b) of the UN MTC, countries significantly increase their right to levy tax on the services provided in their territory, however the important limitation is still the PE test (duration test, same and connected project test).
        - In combination with principles enshrined in Article 7, the profits that the country of source may be permitted to tax are only those profits which may be attributed to the permanent establishment, or profits from activities of the same or similar nature as those carried out by the permanent establishment.[10]
        - On the other hand, the profits resulting from activities taking place less than the given threshold or activities taking place outside of the country of source may not be taxed in the country of source.

Since the threshold of 6 months may be high for certain activities, especially in the extractive sector, a number of countries introduce a lower threshold for the exploration activities. This means that also those activities, which under the UN MTC threshold would escape the Service PE, will be considered to constitute a PE if such a special provision is included.

Furthermore, some countries also define as PE “substantial” equipment used in the exploration or exploitation of natural resources (like Australia, Ghana and other mining countries). The

[10] Article 7 paragraph 1 of the UN MTC contains the so-called “Limited Force of Attraction”, which permits to tax not only profits attributable to the permanent establishment but also profits from the same or similar activities as those carried out by the permanent establishment.

interpretation issues may again arise in this case unless there is specific guidance on what constitutes “substantial” equipment.

- Some countries include in their tax treaties special provisions covering income from “Technical Services”, which permits country of source to levy tax on income derived by non-residents even if the time/location threshold is not exceeded (i.e. even when the PE/fixed base test is not met). This type of provision significantly extends the taxing rights of the country of source and permits the country to levy the tax on the services derived by contractors and subcontractors in respect of the services, which may be provided in the process of exploration activities, consulting or other specialized services.

- Other differences between the UN/OECD MTC (Article 5 paragraphs 4, 5 and 6 (UN)) are of a general nature and apply similarly as between the extractive activities and other business activities, for example also in respect of suppliers of goods/equipment used for the extractive industries, where the UN MTC permits taxation of the business profits, where the enterprise uses the fixed place of business for delivery of goods (Article 5 paragraph 4 of the UN MTC does not consider the delivery of goods as supplementary activities and Article 5 paragraph 5 of the UN MTC may lead to an agency PE, where the agent maintains stock of goods or merchandise on behalf of the enterprise).

In addition to the points addressed above, the tax treaties of certain countries contain specific provisions to grant more taxing rights to the source state on the exploration and extraction of natural resources. These special provisions may include:

- Wide definition of covered off-shore activities (exploration/exploitation of seabed, sub-soil and their natural resources),

- PE threshold reduced in respect of the exploration activities to 30 days,

    - While Preparatory and certain shipping activities may be excluded from the 30-day rule

- Anti-split up provision, preventing the avoidance of a PE by splitting up the contracts into multiple contracts.

<u>Article 6 – Income from Immovable Property</u>

Article 6 provides to the country of location of immovable property a right to tax the income from immovable property without any limitation.

Both the UN/OECD MTCs include in the definition of the term immovable property in Article 6 paragraph 2:”rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources”.

In some treaties a specific (protocol) provision is included clarifying that exploration and exploitation licenses relating to natural resources shall be regarded as immovable property situated in the state to which they appertain (sometimes also deeming such licenses to pertain to a PE situated in that state).

This means that the income derived by non-resident from the operations related to immovable property (including extractive activities) is subject to taxation in the country of source (location of the extractive activities) irrespective of whether the activities may constitute a permanent establishment or not.[11]

Article 7 – Business Profits

Article 7 does not contain any specific provisions dealing with the taxation of the extractive activities; however it contains special rules related to the determination of taxable profits, taxable in the country of source.

While Article 7 paragraph 1 of the OECD MTC permits the country of source to tax only the business profits attributable to the permanent establishment, the same provision in the UN MTC contains a limited force of attraction rule that permits the country of source to also tax profits arising in the country of source of the same or similar nature as those attributable to the permanent establishment. This provision could be especially relevant in the case of exploration or other drilling activities/services, which may be outside of the scope of Article 6. Should some of the activities lead to the creation of a permanent establishment under Article 5 the profits from the same or similar activities carried out in the country of source will also become taxable in this country. This provision thus permits the country of source to levy tax on the activities which would not otherwise lead to the creation of a permanent establishment. There needs to be domestic law to achieve this, as the treaty provision by themselves will not amend the law to allow for such taxation.

There is clearly a significant difference between the rest of the principles enshrined in the UN MTC (2011) and the OECD MTC (2010) in respect of principles related to the determination of taxable profits (attribution of profits to permanent establishment).

In addition, Article 7 paragraph 3 of the UN MTC provides a limitation on the expenses that the PE can deduct in respect of the transactions in relation to the head office.

Article 8 – International Shipping/Air Transport

While Article 8 takes away the taxing rights from the country of source, considerations in the treaty negotiation may be dedicated to the operation of tug boats and similar transport vehicles in the territorial waters and continental shelf – to exclude them from the possible scope of this article.

It should be borne in mind that if the scope of the state has been extended to the shelf any movements of boats etc between on-shore/harbour and a point on the shelf of the same state automatically falls outside the scope of Article 8 (thus the rules related to international traffic do not apply in respect of such activities).

[11] Article 6 paragraph 3 establishes that the provisions of Article 6 apply irrespective of the provisions of Article 7.

Example: Article 6 paragraph 2 – Singapore- UK Tax Treaty

The term "international traffic" means all movements by a ship or aircraft operated by an enterprise of one of the Contracting States, **other than movements solely between places in the other Contracting State or solely between such places and one or more structures used for the exploration or extraction of natural resources situated in waters adjacent to the territorial waters of that other Contracting State.**

Countries may also take care, not to accidentally include other means of transport in the scope of this article, as they may lose the taxing rights over different transport operators involved in the transport of natural resources, which may derive significant profits from transporting the natural resources.

Article 9 – Associated Enterprises

While Article 9 foresees the primary and corresponding adjustments in the case of situations where the transfer prices depart from the arm's length price, considerations could be given to the situations, where the countries operate regulations that require that the transfer price should not depart from a certain price set by regulatory bodies.

Such benchmark prices are for example set by Norway in respect of hydro-carbons and one could assume that these benchmark prices are an arm's length price, however, one could consider whether this specific aspect should be mentioned either in the wording of Article 9 or should be provided as clarification to Article 9 in the protocol to the treaty.

It may be appropriate that further work related to the transfer pricing issues should be carried out in cooperation with the Subcommittee on TP.

Articles 10, 11, 12 – Dividends, Interest, Royalties

These articles may not raise specific issues related to the extractive activities; nevertheless they may still raise issues pertinent to developing countries and tax base erosion.

There is a specific difference between the UN and OECD MTCs in Article 12 - Royalties, where the OECD MTC allocates exclusive taxing right to the country of residence, while the UN MTC allocates the right to tax royalty to the country of source with a limited tax rate. In addition, the definition of Royalty in Article 12, paragraph 3 of the UN MTC extends the definition to include payments for the use of scientific, commercial and industrial equipment – thus permitting the country of source to levy tax on both – payments for the use of intangible property and the payments for the use of tangible property (including rental payment for the specific equipment used in the exploration, drilling, mining and other activities).

The term "Royalty" is often used in the area of the extractive industry in the context of the obligatory payments/taxes related to the extraction of the natural resources. The term "Royalty" thus have different meaning in the context of the tax treaties, where it refers to the payment for the right to use property (in case of the UN MTC both tangible and intangible) and in the context of the

extractive sector, this term also means the obligatory payment for extraction of natural resource – some compare this payment to a purchase price of the natural resource, upon payment of which the extractive company has a right to further sell the natural resource on the open market.

Article 13 – Capital Gains

Some countries[12], which extend the definition of immovable property in Article 6 to include the shares in companies deriving their value from immovable property may tax both direct transfer of extraction/exploration rights and also indirect transfer of such rights via the sale of shares of companies, which possess such rights, in the country of source (where the immovable property is located), through the application of Article 13 paragraph 1.

Other countries may need to include the provision of Article 13 paragraph 4 into their treaties, which provides for the taxing for indirect transfers of immovable property (including exploration/extraction) rights the country of source – country where the immovable property is located.

In this respect, it is important to point out the current limitation in the wording of the UN MTC, which limits the country of source to levy tax on such transfers, where the company is carrying on active business – see the wording of the UN MTC:

> *In particular:*
>
> *(1) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.*

The OECD MTC does not contain such a limitation. It may be advisable for the countries not to include such a limitation in their tax treaties as this may prevent them to levy tax on the capital gains from the transfers of shares of extractive companies.

The issue of the operation of Article 13(4) is considered in detail in a separate capital gains guidance note.

Article 14 (UN MTC) – Independent Personal Services

Article 14 (UN MTC)[13] provides exclusive taxing right to tax independent personal services, unless the non-resident provider exceeds the threshold criterion and has a fixed base in the country of source, or stays in the country in excess of 183 days.

This threshold criterion thus raises similar issues like the threshold criterion of permanent establishment and countries may wish to consider whether similar considerations in respect of specific types of permanent establishment, including the reduced time periods relevant for

[12] For example, France

[13] The OECD has deleted this Article from their MTC, suggesting that Article 7 regulates the taxation of this type of income, including the PE threshold.

exploration/extraction activities shall be introduced and applicable under the provisions of Article 14, where they keep introducing this article in their tax treaties.

Articles 15 – Dependent Personal Services

The provisions of Article 15 provides exclusive taxing right to the country of residence of the employee, with the exceptions, when the employee exercises the employment in the country of source and some of the conditions in Article 15 paragraph 2 are not met (the employee is present for more than 183 days in the country of source, or the salary is paid by an employer who is resident in the country of source, or the salary is born by the PE of the employer in the country of source). This also means that where the shorter time threshold – e.g. 30 days applies to certain activities – such as explorations, the salaries of staff carrying out these activities (connected to the PE) become also taxable in the state of source.

Assuming, the PE definition in Article 5 takes into considerations the specifics of extractive industries, the provisions of Article 15 will reflect the adjustments made in definitions in Article 5 and thus no further changes are required to the tax treaty provisions.

Articles 16– Director's Fees

In respect of Article 16 – Director's Fees, it is advisable to follow the UN MTC, which extends the application of this article also to the top management of companies.

One specific issue that may arise in respect of Article 19 – Government Services is the situation, when the Contracting States established a national oil and gas or mining company. In this case, the activities of the contracting state should be considered as those mentioned in Article 19 paragraph 3 and the provisions of Article 19 paragraph 2 and 3 should not apply in respect of the remuneration received by the employees of these state companies.

Article 21 – Other Income

The UN and OECD MTC differ in respect of the allocation of taxing rights in respect of other income. The types of income, not covered specifically in other provisions of the tax treaty should be subject to tax in the country of residence (in respect of the OECD MTC)[14] and in the country of source (in respect of the UN MTC), when the income is paid from the country of residence.

It is recommendable that the countries follow the UN MTC version of Article 21, since situations may arise that certain payments related to the extractive industries may fall in category of Article 21 (e.g. various compensation payments, payments from insurance compensations, arbitration awards, etc. – assuming such payments would fall under a tax on income covered by the treaty).

Article 22 – Capital

The provisions of Article 22 mirror the treatment and definitions in the tax treaty – it thus refers to the definition of immovable property in Article 6, the definition of permanent establishment in Article 5 as well as the scope of Article 8 – Shipping and Air Transport.

[14] With the exception of cases, when this other income is attributable to the permanent establishment.

Should proper care have been given to the issues and definitions arising in respect of these articles this will be also reflected in the operation of Article 22, which allocates the taxing rights in respect of taxation of capital/property used in the extractive activities. Note that this Article taxes capital itself, whereas the taxation of gains made on capital account is addressed by Article 13.

Article 23 – Elimination of Double Taxation

The specific issue related to the extractive industry would be the obligation of the country of residence to eliminate double taxation, where the country of source was entitled to levy tax on income or capital. Specifically, the question will arise, whether the specific types of taxes levied on the extractive activities fall within the scope of the tax treaty, in accordance to Article 2 and whether the country of residence has to provide credit in respect of the particular type of tax.

Example: Article 23 of Norway – USA Tax Treaty

Article 23
Relief from double taxation

....

The appropriate amount allowed as a credit by the United States shall be based upon the amount of income taxes paid or accrued to Norway. However, the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. In addition, in the case of income taxes paid or accrued to Norway by persons subject to the special tax referred to in subparagraph 2(a)(ii) of Article 1 (Taxes covered), or to a substantially similar tax, the appropriate amount allowed as a credit by the United States shall be limited to the amount of income taxes paid or accrued to Norway attributable to Norwegian source taxable income in the following way:

(i) with respect to income taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway, the amount to be allowed as a credit for a taxable year shall not exceed the product of:
  (a) the maximum statutory United States tax rate applicable to a corporation for such taxable year, and
  (b) the amount of such income;

(ii) further, the lesser of:
  (a) the amount of taxes paid or accrued to Norway on oil and gas extraction income from oil or gas wells in Norway that is not allowable as a credit under subparagraph (i), or
  (b) two percent of such income for the taxable year

shall be deemed to be income taxes paid or accrued in the two preceding or five succeeding taxable years, to the extent not deemed paid or accrued in a prior taxable year, and shall be allowable as a credit in the year in which it is deemed paid or accrued subject to the limitation in subparagraph (i);

(iii) the provisions of subparagraphs (i) and (ii) shall apply separately, in the same way (but with the deletion, in the case of subparagraph (ii), of the words "the lesser of (a)" and "or (b) two percent of such income for the taxable year") to the amount of income taxes paid or accrued to Norway on:
  (a) Norwegian source oil related income not described in subparagraph (i); and
  (b) other Norwegian source income.

Article 24 – Non-Discrimination

Situations, which may give a rise to consideration of tax treatment, which may be considered as discriminatory are the cases in which the host country levies a higher tax rate on the extractive industry operators. However, if this higher tax rates apply irrespective of the residence of the investor or the head office of the extractive company, they are not to be considered as discriminatory.

Similarly, where the host country levies a special branch profit tax, the issue may arise, whether this branch profit tax is in accordance with a tax treaty. The country practices indicate that many countries chose to clarify these issues in Article 24, paragraph 3 or through a special provision inserted in Article 10 (Dividends) or in the protocols to the tax treaties.

- Follow –Up
    - Indicators of success or otherwise in compliance and evaluation.
    - Guidance/ education issues.
    - Audit issues.
    - Administrative efficiency.
    - Enforcement issues (including before the courts).

- Conclusions

To be completed following further discussions

- For more information:

…….. (including relevant IMF, World Bank and other publications discussing the particular issues).