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Capital Gains Issues in the Extractive Industries

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Introduction

This paper describes some of the issues for a country to consider in determining whether, and the extent to which, it should tax natural resource related capital gains. Before making this determination, each country should consider the tax policy it wishes to adopt with respect to capital gains for taxpayers across all industries, not just the extractive sector.

When a taxpayer transfers all or a portion of a capital asset acquired for use in its business (e.g., property, plant, equipment, and license rights), general income taxation rules in many countries treat some or all of the gain as taxable. Countries that impose capital gains taxes also often treat some transfers as non-taxable, the most common being certain business reorganization transactions. In designing their tax regimes, countries therefore need to determine whether to tax capital gains in the first place, and if so, whether certain transactions should be exempt from the tax (or whether the tax should be deferred for some period).

Where a transfer occurs outside the taxing country that has the effect of transferring the ownership of assets within the country, such as via the sale of shares in a company that owns the in-country assets (or the shares of a subsidiary that owns such assets), a further question arises as to the ability, and the desire, of the country to impose its capital gains tax on such "indirect" asset transfers. The taxation of these so-called indirect transfers is a hotly debated issue. Without going into depth on the complex issues raised in seeking to tax indirect transfers, this paper will address some considerations a country may weigh in determining whether, and how, to tax indirect transfers related to natural resource transactions.

General Principles for All Industries

- As noted, the first principle should be to identify and decide if, and which, transactions will give rise to capital gains taxation as a general matter.
- If transactions are generally taxable, it is likely that a country will want to identify and consider the scope of any exceptions to taxation, such as "restructuring" or re- organization transactions or gains arising from currency valuation changes where no gain in "real" terms exists.[1] Whenever a transaction is treated as taxable, a fundamental correlative rule is that the tax basis of the assets in the purchaser's hands should be the price it pays for such assets. This can be described as resulting in a "stepped up basis" if the assets are sold at a gain.[2]
- If a transaction within a country is considered to be taxable, the country must further decide if it should tax a transaction occurring outside the country which has the effect of "indirectly" transferring ownership of the in-country assets.
- In making the determination on taxation of "indirect transfers", a country should identify the pros and cons of asserting taxation on such an out of country event (e.g., time value benefits, public perception, compliance, and administrative burden issues, and resources required to maintain and implement such a tax regime).
- If a country does decide to tax "indirect transfers," it should:

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- Only tax those transfers which, if done within the country, would be taxable, and
- Provide a mechanism for an in-country step up in basis to achieve symmetry between direct and indirect transfers.

Application to Extractive Industries

The general principles outlined above are equally applicable to extractive industries. Specifically with respect to oil and gas, it is common for large projects to be conducted in joint ventures, with several participants, rather than by one investor. This is a typical risk and cost management approach for multi- billion dollar investments. Countries seeking to maximize the potential of their resources can benefit from policies which promote the efficient addition of other partners or co-investors, including by permitting partners to join a project without triggering a tax, especially where no net cash is involved.

Interests in oil and gas projects are often transferred in ways other than an outright sale. As noted above, an investor frequently brings in other partners at various points along the development of a project. In an oil and gas farm-in transaction, a new partner may enter a project with an obligation to reimburse the existing investor for a share of its "sunk costs" and/or an agreement to bear future costs—either proportionate or disproportionate to its "acquired" interest. In such cases, even if some cash changes hands, it does not necessarily create an economic gain.

To illustrate:

- Assume investor A negotiates a contract with Country X to explore for and develop an oil and gas project. As a part of the negotiation, Country X carefully chooses a mixture of fiscal terms to provide it with a certain amount of (i) up front revenues (e.g., via bonus or other upfront payments or investment requirements), (ii) revenues based on production, irrespective of profitability (e.g., via royalties based on the gross value of the production), and finally (iii) other revenues based -- and only due -- upon profitability (e.g., via income or excess profit/ rent taxes).
- Assume that Country X calibrates its government take with the notion that investors typically calculate returns on a discounted cash flow basis, with a discount rate somewhat higher than the country's cost of funds rate.[3] Under this assumption, revenues (or lower costs) earlier in the project life are worth more to the investor than to the country on a present value basis.
- Because investors calculate required returns needed on a discounted cash flow basis, both the absolute amount of the revenues they obtain as well as the timing of their receipt affect the viability of (and the amounts they can invest in) any project. Note: The fact that timing differences are often more "valuable" to investors than they are "costly" to countries on a present value basis is an important tool for countries to use to their benefit.
- Assume that after investor A has spent $1 million, it agrees that in return for investor B reimbursing A for half of its spent costs, plus the agreement to bear 50% of all future costs, investor B will become a 50% partner along with A.
- It is suggested that whether this transaction occurs within Country X or via an "indirect" transfer outside the country, no tax should be due on the transfer of the 50% interest since no net cash is involved in the transaction.
- Now assume instead of the transaction above, investor A simply sells a 50% interest in the venture to investor B for $5 million (i.e., at a $4.5 million gain on the 50% interest sold), and thereafter investor B, as a 50% partner, bears 50% of all ongoing costs.
- Country X has a choice—it can tax the $4.5 million net gain to A, gaining some income tax revenues earlier in the life of the project, but recognizing that investor B has an additional $4.5 million cost basis in its 50% share. Future tax revenues from investor B's share will be reduced in an amount equal to the income tax paid by investor A at the time of the transfer. This may seem an easy decision, in that the government may find it irresistible to give up current revenues (the "bird in the hand") versus waiting for future revenues (the "bird, or birds, in the bush," as explained below). However, given that an upfront cost (A's tax) is generally viewed as more costly to investors than the benefit of the offset of such costs later in the project life (to investor B), this treatment actually can make the transfer to B quite costly to the investors on a present value

basis. This "friction" can make it more difficult for investor A to bring in investor B, which may lead to inefficiencies in the development of the resource, outweighing the timing benefit to the country of the revenues it receives. Thus, Country X should weigh the "all-in" costs of this approach compared with its benefits (i.e., a timing difference for receipt of revenues).

- This is why, for example, a country like Norway has decided not to tax transfers, whether in country or indirectly effected.[4]

Nevertheless, it is often asserted that transfers of large scale extractive facilities should bring an immediate return to the government, given that profits may be seen as significantly deferred. Thus, capital gains should be taxed.[5]

Recall, however, that if a government has carefully crafted a revenue stream consisting of near, intermediate, and longer term revenues, then taxing capital gains upsets that revenue profile by accelerating the longer term revenues from originally planned.[6] And since investors view the cost of this acceleration as higher than the country would view the benefit, this is a net loss in present value terms for both.

The issue is much more of a political than an economic one. The sale of the interest at a gain provides the government a chance to deviate from the original allocation of revenues that it designed. If the government wants to stay with its original revenue profile over the life of the project, it finds itself having to explain this rationale to the public. While the economic argument is a compelling one (i.e., that the government can receive more total revenues by foregoing the capital gains tax), it is nevertheless a bit more politically difficult to articulate.

Should a country tax capital gains on sales of natural resource properties? This is a tax policy question. Where a country generally taxes capital gains of other businesses, it may conclude it is appropriate to tax gains on sales of natural resource properties as well, either under its general income tax statutes or statutes applicable to natural resource taxation. There may be reasons, however, not to apply capital gains taxes to natural resources -- given (i) their unique timelines (i.e., projects lasting over decades) and often large contributions to country revenues over such periods of time, (ii) that fiscal terms for such large projects, if designed carefully, should be calibrated to provide a balanced mix of revenues over long project lives, (iii) that taxing a capital gain merely accelerates tax revenues from future periods into the period of the sale transaction, providing for no additional revenue but undermining the balance of the desired revenue mix (see additional comments below), and (iv) that gains based on volatile commodity values, which often erode thereafter, are somewhat illusory (and without allowing for losses based on volatility can be asymmetrical and a disincentive to investment).[7] Finally, taxing certain capital gains could unintentionally raise the overall tax and government take rate beyond competitive levels or discourage otherwise critical merger or acquisition activities. Whatever a country decides to do, it should be clearly articulated in the law to avoid uncertainties and the need for interpretation.

The Importance of Symmetry[8]

Capital gains taxation rules are important both to the buyer and the "taxpaying" seller. When a seller is taxable on its gain, the buyer takes its purchase price as its beginning tax basis for measuring future income or capital gains. Unless this occurs, the structure of the tax law itself will impose double taxation, contrary to basic taxation principles. This "symmetry" is clearly understood as an important principle for in-country, direct sales of operating assets, and its impact is equally important in the case of indirect sales if a country considers taxing such sales.

Symmetry can be provided either by taxing gains and allowing the buyer a "stepped up" basis or not taxing the gain to the seller, but only allowing the buyer a "carry over" basis (i.e., based on the seller's costs).

Symmetry examples:

- **Background.** The importance of symmetry can be illustrated via the following fact pattern: Investor A owns and operates an oil well in Country X. Investor A is a resident of Country X and is owned by Holdco, which is a resident of Country Y.

  Investor A's well is expected to generate net cash (cash revenues less cash operating/ capital expenses) of $100,000 for each of the next ten years. For tax purposes, Investor A's well is fully depreciated and there are no other differences between net cash and taxable income during the ten year period. Assuming a Country X tax rate of 50%, Investor A expects to generate after-tax net cash of $500,000 over ten years ($100,000 x 10 = $1,000,000 pre-tax net income – 50% tax rate = $500,000 after- tax net income); Country X will receive

$500,000 in tax revenues over the same ten-year period.

Assume Buyer expresses an interest in acquiring Investor A's well. Ignoring time value of money issues for simplification, Investor A will likely demand an after-tax sales price of approximately $500,000 which is its expected after-tax cash from retaining the well. Buyer can be expected to be willing to pay a sales price that is no more than the after-tax cash that it expects to receive from the well. The tax treatment of the transaction will have a significant impact on whether the parties will be able to agree upon a price. If the tax rules of Country X allow for symmetrical treatment, then there would be no tax impediment to Investor A and Buyer reaching a deal.

- **Symmetry Case One – Seller's Gain Taxed / Buyer Deducts Purchase Price.** Assume for simplicity that Buyer is willing to pay $1,000,000 for the well. Assuming the well is expected to generate net cash of $100,000 per year over ten years, the Buyer's future depreciation deductions (that were not available to Investor A) will offset taxable income generated from the well. The Buyer's future net after-tax cash generated is $1,000,000 and, under these simplified facts, it "breaks even" on this investment.

	Cash ($)	Tax Calculation ($)
Income	1,000,000	1,000,000
Tax Deduction	--	(1,000,000)
Taxable Income	--	0
Tax	0	0
After-Tax Cash	1,000,000	

Investor A's $1,000,000 is taxable at 50%, but its after-tax cash of $500,000 is what it expected to receive from continuing to own and operate the well. Finally, Country X receives the same $500,000 in revenue that it would have received absent a sale.

- **Symmetry Case Two – Seller's Gain Not Taxed / No Deduction for Buyer (typical offshore indirect sale).** In this case, for Buyer to have a "break-even" investment, it would only be willing to pay $500,000 for the well (i.e., the expected after-tax cash generated from operation of the well). The Buyer essentially steps into the shoes of Investor A, taking A's tax basis (in this case, zero), and thus has the same after-tax result that Investor A would have had: $1,000,000 of before-tax cash generated from the operations less $500,000 of tax paid, netting $500,000 of after-tax cash. Investor A finds the $500,000 sales price acceptable because it is not subject to tax and therefore its after-tax cash from the sale is also $500,000. Finally, Country X again receives $500,000 in tax revenues and is in the same position as before.

- **Analysis.** These two fact patterns demonstrate, contrary to assertions frequently made, that a seller cannot avoid the economic impact of a local country tax through an offshore sale. Such a sale, even if not currently taxed, does not deprive a developing country of tax revenues. Notice that in such a case Investor A bears the full brunt of the Country X tax. Buyer's calculation of the price it is willing to pay to Investor A is based on the after-tax cash flow that it expects from the well. Even though the well generates $1,000,000 of revenues, Buyer is only willing to pay $500,000 to Investor A since Buyer will also owe tax of $500,000 over the life of the well. Country X also is kept whole, receiving its $500,000 of revenue.

- **Nonsymmetrical Treatment Case One – Seller's Gain Taxed / No Deduction for Buyer.** Under these rules, Buyer will only be able to break-even by paying Investor A $500,000 for the well because that is the expected after-tax cash flow from the well ($1,000,000 pre-tax income minus 50% income tax). For Investor A, a payment of $500,000 is insufficient because the sale would be subject to $250,000 of tax by Country X ($500,000 x 50% income tax), and therefore, Investor A's after-tax cash is only $250,000. This results in an effective tax rate of 75%, i.e., double taxation.

  While some may argue that this tax result is favorable for Country X because it will receive $750,000 of tax revenues, it is unlikely that this will ever materialize. As stated previously, the sales transaction will only take place if Investor A and Buyer can arrive at an agreeable price. Under this tax regime, the likelihood of that happening is extremely low. Far more likely is that the sales transaction will not take place, Investor A will remain operator of the well, and Country X may lose a more efficient

operator or one more willing to make additional investments.

- **Nonsymmetrical Treatment Case Two – Seller's Gain Not Taxed / Buyer Deducts Purchase Price.** Under these rules, Country X would subsidize the sales transaction between Investor A and Buyer. For the reasons explained above, Buyer would be willing to pay $1,000,000 for the well. Seller would receive a windfall in this case because the after-tax cash to the seller would also be $1,000,000 if the sale is not subject to tax. Country X would receive no tax revenues under this regime.

A tax regime that provides symmetrical treatment for a seller and buyer protects the country's revenue and does not present an economic impediment to investors seeking to maximize efficiencies.

Even if a system is designed to create symmetry, the question remains as to which approach is better, i.e., taxing the seller's gains and providing a step up in basis to the buyer or not taxing the seller's gains and requiring the buyer to carry over the seller's basis (i.e., not permitting the buyer tax deductions based on its purchase price). This ultimately is a question of timing. For example, under the example above, if the gains are taxed, then Country X receives a lump sum of $500,000 in year 1 and then nothing in future years. If the gains are not taxed, Country X continues to receive a steady stream of $50,000 in revenues for the next ten years.

Which is best for Country X?

- As noted, the present value cost of an outlay to an investor (e.g., a tax payment) is generally more than the present value benefit to a country from an acceleration of a payment, given their discount rate differences. Thus, value -- which otherwise could benefit both the investor and the country -- is lost when, all other things being equal, a country accelerates a tax cost.
- Many other factors come into play, but one additional item that a country might consider is how it would account for a one-time acceleration of expected revenues for budgeting and spending purposes. Would such a one year spike in revenues be viewed as such and effectively "saved" for use in future periods, or would other pressures force government officials to spend the revenues when received? Alternatively, would it be better from a fiscal management perspective to maintain a steady stream of income through-out the future years?
- These are among the considerations a country will need to weigh in making its policy decision on this important issue.

Indirect Sales Additional Points

When a country evaluates whether it should tax "indirect" sales, a number of additional issues arise.

- The overall benefit should be determined, given that it is in fact only one of timing.
- Costs of such an approach should also be evaluated. In addition to the costs to investors which may reduce overall country investment in general, the administrative issues and costs of implementing and enforcing such an approach need to be considered. The country will need to design how best to achieve tax symmetry (i.e., how it will deal with the "stepped up" basis issue noted above) and otherwise how it will prevent double taxation possibilities.[9] In addition, the country will need to consider issues regarding the scope of its tax jurisdiction, its treaty provisions, how it will identify and track transactions, which transactions it may wish to exempt,[10] its enforcement capabilities, and the allocation of its tax administration resources.
- Following its cost/benefit analysis, it may be that a country still decides to tax indirect transfers; but equally a country may determine that the difficulties such an approach creates are simply not worth the timing effects in revenue collection.

Endnotes

[1]For example, the Commentaries to the UN Model state that while *"capital gains which are due to depreciation of the national currency are covered…[i]t is, of course, left to each State to decide whether or not such gains should be taxed".* (See Paragraph 11 in the Commentaries on Article 13 of the United Nations Model Double Taxation Convention).

[2]The difference in treatment of a taxable versus non-taxable transaction is generally a timing issue for a country. Assume Taxpayer A has an asset with a built in gain of $1,000. If it continues to use that asset in its business, it will pay tax on the future income from the use of that asset (assume that future income is $10,000). If instead A sells the asset to B, B will have an extra cost basis in the asset equal to the $1,000 gain. B will be able to depreciate this extra cost basis over the life of the asset, so instead of earning $10,000 of future income, it will earn $9,000. The total income earned remains $10,000, with $1,000 taxed to A and $9,000 taxed to B if a capital gains tax is imposed on A. Where A's sale to B is not taxable, the $10,000 of income will all be taxed to B.

[3]See for example the IMF Fiscal Analysis for Resource Industries (FARI) model assumption that an investor will do project specific economics, requiring a return to compensate for the risks of that specific project, including specific country risks as well, rather than using as its discount rate an overall enterprise weighed average cost of capital. This generally results in the investor discount rate on a specific project being higher than the applicable country's cost of funds rate. Additional background on the FARI model is available at: https://www.imf.org/external/pubs/ft/tnm/2016/tnm1601.pdf.

[4]While capital gains from transfers of assets located on the Norwegian continental shelf are potentially taxable, in practice most asset transactions are exempt from tax under section 10 of the Petroleum Tax Act. Where the requirements of that section are met, including receiving consents from the Ministries of Finance (MOF) and Petroleum and Energy (MPE): *"…capital gains arising from the transfer of assets that are allocated to the petroleum tax regime are not taxable and losses non-deductible (neither when calculating ordinary petroleum tax nor special tax). Moreover, the buyer will take over the seller's tax balances (including the basis for uplift) and other tax positions and stand in the shoes of the vendor….*

The rationale for these rules is that the Norwegian state's tax revenues from upstream activities should be unaffected by a transfer….[C]onsent from the MOF is also required for an indirect transfer such as a share deal implying a change of control. Such deals are, in practice, straightforward from a tax perspective as there are no withholding taxes regardless of where the shareholder is a resident."

Deloitte, *"Oil and Gas Taxation in Norway",* 2014, p. 6, *http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Energy-and-Resources/gx-er-oil-and-gas-taxguide-norway.pdf.*

[5]*"It is often argued that it is politically unfeasible in developing countries not to tax billion dollar sales of the right to exploit national resources. One of the very few ways that a government can extract revenue from extractive sector projects that will not generate a profit for years or even decades is to impose a tax on capital gains.*

The early injection of substantial revenue from capital gains taxes is obviously very welcome. In some cases it is seen as a major victory over powerful international companies and a redress to generous tax concessions offered in the original contracts. The significance of capital gains tax payments is often not well understood. In most countries, the capital gains tax is deductible against future assessments of taxable income. This means that a capital gains tax is not an additional source of government revenue. It does enable the government to bring forward some future revenue. But it also generates additional deductions against company taxable income. Securing early revenue in advance of production delays the onset of profit based taxes (IRPC) and pushes back the date when government revenues will become significant. The resulting offset in medium-term government revenues is considered, if it is even considered at all, a small price to pay for substantial early revenue."

'Taxing "Capital Gains" in Mozambique's Extractive Sector', Centre for Public Integrity, May 2014, http://www.cip.org.mz/cipdoc/307_Spinformacao_2014_04_en.pdf.

[6]This assumes that the government has not factored into its planning regarding the timing of overall tax revenues for a certain amount to come from capital gains. In other words, if a country develops an overall tax regime with capital gains taxes as an important part, and it otherwise adjusts other parts of the regime to take this into account, then it can be argued that the "acceleration" of revenues that a capital gains tax provides is in fact a key ingredient to the overall tax system. This would seem to be more likely in a developed and diverse economy, with a relatively predictable and regular amount of revenue available from capital gains taxes (based on a number of years of experience). It may be less applicable in the case of a developing country, with a relatively non-diverse economy, and one or two sectors providing the bulk of its income tax revenues.

[7]Again, note that if such gains are taxed, the stepped up basis will, over time, provide an offset. But, timing is highly relevant to investor discounted cash flow returns, and further, if ongoing income is insufficient to cover the basis step up, a portion of the gain would be taxable while the corresponding loss is not tax effected, giving rise to asymmetry and in effect, double taxation.

[8]This section is largely based upon a part of a forthcoming paper from the UN Committee of Experts on International Cooperation in Tax Matters entitled "Note on Capital Gains Taxation and Taxation of Indirect Asset Transfers." The October 15, 2015 draft of the paper is available at http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_Attachment2_Cgt.pdf.

[9]There are several issues that can give rise to a conflict of interpretation and double taxation in the case of indirect transfers; for example (i) alienation of shares of a holding company owning a participation in more than one subsidiary in the source country (e.g., a subsidiary that falls under the immovable property rule and another subsidiary that does not fall under this rule) but, because the source country uses a consolidated valuation method (instead of a value test applied separately to each of the subsidiaries), the indirect capital gains rule is triggered for both subsidiaries, or (ii) the alienation of shares of multi-tier groups (e.g., alienation of a top holding with a chain of subsidiaries resident in different states). Moreover, if a particular Production Sharing Agreement attributes joint or alternative tax responsibility to the acquirer, multiple taxation might derive from a single transaction.

[10]Indirect transfers potentially subject to tax can have a very broad scope and apply even when an investor sells shares representing a very low interest of the capital in the immovable company. The OECD commentaries acknowledge the broad scope of the provision but suggest countries may restrict its application to cases where the alienated shareholding does not exceed certain thresholds. They further point out that countries are free to exclude from the scope of taxation gains derived from the alienation of listed companies. (See Paragraph 28.6 in the Commentaries on Article 13 of the OECD Model Tax Convention).