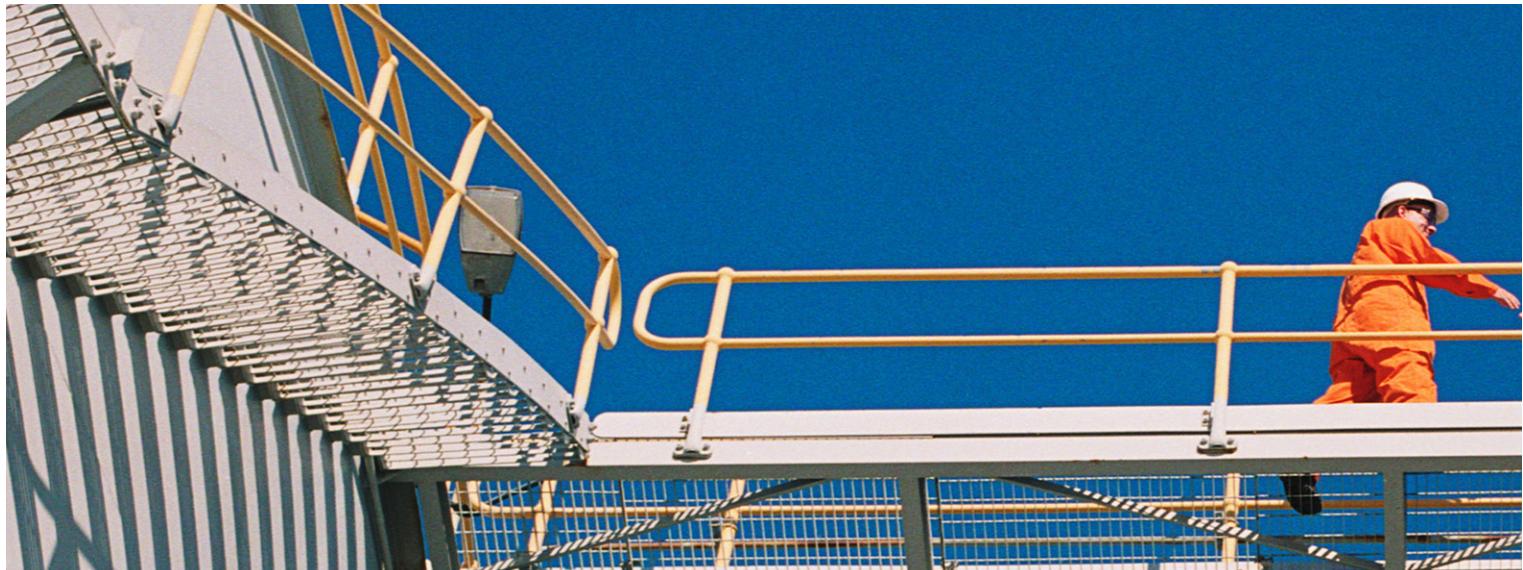


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Production Sharing Contracts (“PSC’s”) – new tax implementing regulations under GR79

The Ministry of Finance (“MoF”) has just released 3 implementing regulations under GR 79 addressing the following topics:-

- a) Parent Company Overhead (“PCO”) Allocation Cap (PMK 256 dated 28 December 2011);
- b) PSC Transfers and PSC Uplifts (PMK 257 dated 28 December 2011);
- c) Expatriate Remuneration Cap (PMK 258 dated 28 December 2011)

The following is a high level summary of the regulations.

PCO Allocations (PMK-256)

Key features:-

- a) PMK 256 stipulates the cap for PCO allocations of 2% of annual spending for cost recovery and tax deductibility purposes, in furtherance of Article 12(2)(f) of GR 79. It does not address the allocation calculation or methodology. The principles in PMK 259 are broadly as regulated in GR 79, with clarification on the approval required in either the Exploration or Exploitation phase as discussed below.
- b) PMK 256 confirms the cap of 2% p.a, however the amount a PSC is able to actually recover will be dependant upon approval from BP Migas, which may be lower than 2%. The type of approval required depends on whether or not the PSC is in the Exploration or Exploitation phase as follows:

- **Exploration:** the approval is to be ascertained from the work programme & budget ("WP&B"), and monitoring of the allocation cap will be done over the exploration period (i.e it would not be adjusted until the end of the exploration period); or
- **Exploitation:** specific written approval must be obtained from BP Migas and the cap will be monitored each year (i.e the WP&B will not be sufficient evidence to support the allocation once Exploitation has commenced).

c) The regulation is silent on the exposure to WHT/VAT and does not address the effect of the longstanding MoF-S-604

PSC Uplifts/PSC Transfers (PMK-257)

PSC Transfers - Key features

- a) Consistent with GR79, tax is due on a PSC transfer at the rate of either 5% (for exploration PSCs) or 7% (for producing PSCs). The tax due is calculated based on the actual amount received by the vendor.
- b) Branch Profits Tax ("BPT") is also due on the transfer and at the rate of 20% of the "economic profit" less the 5% or 7% tax already paid on the transfer.

PwC observation: the application of BPT to a transfer of a direct interest in the PSC essentially subjects the transfer to two layers of tax and arguably represents an extension of the scope of GR79 .

- c) The regulation implies that profits on share transfers are also subject to both the 5% or 7% transfer tax and BPT, although the BPT is seemingly only applicable for transfers from 1 January 2012 as per the transitional provisions (see below).

The assertion that share transfers can be subject to BPT at the PSC level raises a number of concerns. Treaty issues could also arise.

- d) There is also no elaboration on the tracing arrangements where a share transfer occurs further up the corporate chain. The regulation does provide an example of a taxable transfer which involves the sale of shares in a PSC entity resident in a non-treaty jurisdiction, but does not provide any guidance on transfers in treaty jurisdictions.

PwC observation: the taxation of offshore share transfers in "tax-haven" treaty jurisdictions is consistent with the general tax law. However, treaty protection may still be available;

- e) The term "Exploration" is defined as being the period from the effective date of the PSC until the approval date of the first Plan of Development ("PoD").
- f) The payment of the transfer tax is due at the earlier of actual payment, title transfer or formal approval by the Minister of Energy and Mineral Resources. This is extended further to 10 February 2012 where the transfer occurred between 20 December 2010 and 31 December 2011;
- g) The tax remittance and reporting obligations are as follows:-
 - i). for a sale of a direct working interest, if the purchaser is already tax registered the purchaser must report, withhold and remit the transfer tax to the Tax Office. If the purchaser is not registered, then the purchaser should remit the tax in the name of the vendor;
 - ii). if a share sale then the purchaser entity should remit on a tax payment slip in the name of the vendor; and
 - iii). in any case, at least one of the parties must report the transfer within 14 days of the SPA being signed and attach the SPA and latest FQR with the report.

PwC observation: these reporting provisions are not entirely clear, especially for share sales. The rules do however seem to support the view that this is a withholding tax and so ultimately a tax upon the vendor. Another area of uncertainty arises in the case of deferred consideration or on a farm-out of an interest through future funding of the associated cash calls.

h) transitional rules indicate that for transfers from 20 December 2010 until 31 December 2011 the provisions on BPT are not applicable.

PwC observation: the transitional provisions provide that the BPT imposition is prospective only, whereas the 5% or 7% transfer tax is payable from the date of effect of GR79. It is not clear what the formal position is on pre-GR79 transfers.

i) the regulation elaborates on the circumstances where an exemption from the 5% or 7% transfer tax will be applicable under the “risk-sharing” provisions of GR 79. In summary, the regulation provides examples to illustrate what is meant by “no profit” arising on the transfer. The 3 examples given are:

- where the purchaser pays for a proportion of the existing cost pool, equal to the percentage ownership transferred;
- where the purchaser agrees to meet future carry costs until the costs incurred are equal to the costs associated with the percentage ownership to be obtained; and
- “Sole-risk” arrangements whereby the purchaser provides no consideration for the existing cost pool and only contributes to future costs in proportion to its ownership percentage, but the Vendor is entitled to fully recover its proportion of the cost pool transferred from future cost recovery.

Uplifts

Key features of the tax on uplift include that:-

- an “uplift” is defined as compensation provided to finance a PSC partner for the purpose of PSC operations;
- uplifts are taxable on a final tax basis at the rate of 20% plus BPT. There would not appear to be an entitlement for the uplift payer to receive a deduction for this payment;
- the tax is due at the earlier of payment or accrual of the uplift by the payer.

Expatriate Remuneration (PMK-258)

Key features include the following:-

- PMK 258 provides details on the applicable cap on expatriate remuneration for cost recovery and tax deductibility purposes, in furtherance of Article 12 annual (2)(f) of GR 79. Remuneration is not well defined, but seems to cover short-term compensation only. The cap depends on the role and the relevant region that the expatriate comes from (based on passport) as per the table below:

Position Classification	Rates for expatriates who hold a passport from			Remarks
	Asia, Africa, and Middle East Region	Europe, Australia, and South America Region	North America Region	
HIGHEST EXECUTIVE	USD	USD	USD	1 st Ranking Position in Contractor of Oil and Gas Cooperation Contract (President, Country Head, General Manager)
	562,200	1,054,150	1,546,100	
EXECUTIVE	449,700	843,200	1,236,700	2 nd Ranking Position in Contractor of Oil and Gas Cooperation Contract (Senior Vice President, Vice President)
MANAGERIAL	359,700	674,450	989,200	3 rd Ranking Position in Contractor of Oil and Gas Cooperation Contract (Senior Manager, Manager)
PROFESSIONAL	287,700	539,450	791,200	4 th Ranking Position in Contractor of Oil and Gas Cooperation Contract (Specialist)

- b) Although the cap applies for cost recovery and tax deductibility purposes, the Article 21/26 employee income tax withholding obligation of the PSC contractor is still subject to the prevailing income tax law, therefore Article 21/26 withholding appears to still be based on the actual payments to expatriates.
- c) An exception applies where a particular expatriate has highly specialised and very rare skills, subject to obtaining MoF approval.
- d) The cap is effective from 1 January 2012, and is to be re-evaluated within 2 years of the effective date.

We will be monitoring developments with these regulations and keep readers updated as changes occur.

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