INTERNATIONAL TAX AND INVESTMENT CENTER

Platform for Collaboration on Tax

Taxing Offshore Indirect Transfers: A New Toolkit

An Investor's Perspective

23 July 2020

COMMENT SUMMARY: AN INVESTOR'S PERSPECTIVE

I. **Toolkit is not a recommendation and leaves decision for each country** (Toolkit p. 9)
   - Countries should have greater information on the option not to tax
     - Norway and the United States don't (Toolkit p. 20, footnote 27)

II. **Reasons not to tax OITs involve interplay of investor/country perspectives**
   - Reducing investor risks can increase country income
   - Ability to add/change investors can increase country income
   - Taxing OITs may reduce value to a country
   - Adding administrative complexity and diverting resources increase country costs/risks

III. **IF tax OITs, need to avoid double taxation/retroactivity**
   - Need to step up basis of in-country assets
   - Losses need to be deductible (including carrybacks/carryforwards)
   - Law changes should be prospective only

INTERNATIONAL TAX AND INVESTMENT CENTER

RISK

"It's all about risk and reward……Offering a stable, consistent and predictable tax environment, with a fair, transparent and timely appeals process is very valuable to IOCs. If you can convince them that you will provide this they will accept a higher government take." [Quoted in UN Handbook on Taxation of the Extractive Industries]

- **Countries competing for capital affirmatively use risk reduction to maximize value**
- **Corollary is where risks are increased, investors will require a greater return**
  - Barriers to entry of new partners increase risks/reduce "optimization" prospects
- **"Predictable tax environment" certainly means no retroactive tax changes**
  - If investor can't rely on law in place, risk increases—lowering government take

INTERNATIONAL TAX AND INVESTMENT CENTER

COMPARE COUNTRY REVENUES WITH NO SALE CASE

- **Country/Investor agree on exploration and development terms**
  - Reflects expectations of each, both in amount and timing of revenues
- **Investors calculate returns on discounted cash flow basis at project rates** (not external borrowing or cost of capital rates—See IMF FARI model)
- **The net income from the property/project is what is available for sharing—no more and no less** (Toolkit Box 1 explanation, p. 14)
  - Agreement terms should promote, not discourage, activities that increase overall project value
- **What happens if there is a partial or total change of investors?**
  - If not taxable, original terms simply remain in place—no acceleration or deceleration
  - If taxable, it accelerates—or decelerates if at a loss—the expected cash flows to country

INTERNATIONAL TAX AND INVESTMENT CENTER

PRACTICAL IMPLICATIONS

- **Country's revenues are same over the project irrespective of OIT tax decision** (Toolkit pp. 15 and 16)
- **Receiving $1000 today versus 10 years later, creates a $450 time value benefit at a 6% country borrowing rate (Toolkit p. 15).**
- **But what about the investor? An investor "paying" $1000 today, and recovering it 10 years later, suffers a time value "loss" of $700-800 using its risk-weighted discount rate of 12-15%.**
  - Certainly doesn't encourage bringing in new partners—increasing risks
- **BUT this illustrates the potential win-win "sweet spot" of different discount rate perspectives**
  - A country can increase absolute and present value of revenues by deferring a timing difference
- **Clearly should be considered in structuring agreed fiscal terms, including whether to tax OITs**

INTERNATIONAL TAX AND INVESTMENT CENTER

CONCLUSIONS

- **Considerable "momentum" to tax OITs-- BUT it actually is a choice!**
- **The choice to tax has economic impacts that should be understood**

COUNTRY SHOULD FULLY EVALUATE THE PROS AND CONS BEFORE MAKING OIT DECISIONS

- **If after full analysis, a country does decide to tax OITs:**
  - It needs to "step up" the basis in the in-country operating assets
  - It should treat losses the same as gains—with tax carryback/forward mechanism
  - The scope of taxation on an OIT should be no greater than on a domestic transaction
  - The law should be clear on all of these points—neither taxpayer nor tax administrator should have to guess
  - If a change in law is desired, it should prospective only

INTERNATIONAL TAX AND INVESTMENT CENTER

Platform for Collaboration on Tax

Taxing Offshore Indirect Transfers: A New Toolkit

An Investor's Perspective

23 July 2020