



Extractive Industries Taxation Issues Related to Tax Treaties

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Overview

- Application of Art. 6 and 7 in the case of mining and oil / gas extraction
- Coverage of exploration activities and activities on the continental shelf
- PE issues related to the exploration and extraction of natural resources

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Application of Art. 6 and 7 UN Model in the case of mining and oil/gas extraction

Art. 6(1)

Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

- Art 6(1) covers
 - Income from immovable property, and
 - Income from agriculture or forestry
- Art. 6(1) only applies to income that a resident of State A derives from immovable property in State B; income from immovable property in State A or in third States is covered by Art. 21

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Definition of immovable property – Art. 6(2)

The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property **and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources**; ships and aircraft shall not be regarded as immovable property.

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Meaning of income from immovable property – Art. 6(3)

The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.

- Important to distinguish between income derived “from” immovable property and income derived “using” immovable property

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Income “from” immovable property

- Income derived “from” immovable property means “the income that results directly from the ownership or possession of real property” (as indicated in the Commentary on the 1943 Mexico and 1946 London Model of the League of nations)
- This includes typically
 - The imputed rent of an owner-occupied house (taxable in some countries): this corresponds to “the direct use” of the property
 - The rent that the owner or possessor of the immovable property gets from letting other people use it (e.g. rent for an apartment that is rented out)

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Income “from” immovable property

- Income “from” immovable property **does not** include business profits simply because an immovable property is used in the carrying on of that business
“...**Income derived from the exploitation of** lands, buildings, and **sub-soil as a part of a business ... does not come within the purview of Article II, but of Article IV, concerning business income**” (Commentary on the 1943 Mexico and 1946 London Model of the League of Nations)”
- Example: business profits from selling minerals extracted from a mine (or oil/gas extracted from a well) that is owned by the company that operates the mine is not covered by Art. 6 even though immovable property is used in that business

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Agriculture and forestry *versus* mining, oil/gas extraction

Unlike agriculture and forestry, income from mining is covered by Article 7 and not by Article 6 **but**

- Article 6 applies to “...income derived from the direct use, letting, or use in any other form of...” [Art. 6(3)] and
- The definition of immovable property includes “... rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources” [Art. 6(2)]

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Rights to the extraction of natural resources

- In many countries ownership of land does not include ownership of underground minerals, oil and gas
- In order to be able to extract minerals, oil or gas, an enterprise must therefore obtain “extraction” rights, usually from the State
- These extraction rights constitute “immovable property” under the part of the definition of Art. 6(2) that refers to “rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources”

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Application of treaties to mining and oil/gas production

- Therefore, any payments that would be made by the operator of the mine or well to the owner or possessor of the extraction rights would be income covered by Art. 6 (i.e. “resource royalties” are covered by Art. 6)
- However, profits from activities related to the extraction of minerals (i.e. the mining, which consist in extracting and selling the minerals) or oil/gas are covered by Article 7
- Are these profits taxable in the State of source? This depends on whether there is permanent establishment situated in that State

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Definition of permanent establishment

- UN Model basic definition of PE in Art 5(1): “a fixed place of a fixed place of business through which the business of an enterprise is wholly or partly carried on”
- List of examples in Art. 5(2) UN Model:
 2. The term “permanent establishment” includes especially:
[...]
 - f) ***a mine, an oil or gas well, a quarry or any other place of extraction of natural resources***

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Coverage of activities on the continental shelf

- Under Art. 7(1) UN Model, a State may only tax profits of a foreign enterprise “if the enterprise carries on business in [that] State through a permanent establishment situated therein”
- A PE represented by a mine or other place of extraction of natural resources must therefore be situated in the State of source for that State to be able to tax
- Exploration will often not be covered by Art. 5(1) but maybe covered by Art. 5(3)b) (service PE)
- This raises difficulties in the case of offshore exploration and extraction of minerals, oil and gas on the continental shelf

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Continental shelf

- Under international public law (*United Nations Convention on the Law of the Sea*) the continental shelf is part of the “exclusive economic zone”, which is an area beyond the territorial waters of a State over which that State has exclusive jurisdiction (including taxing jurisdiction) with respect to natural resources
- The exclusive economic zone is not, however, part of the territory of a State
- An oil or gas well located on the continental shelf but beyond the limit of the territorial waters is not therefore “situated” on the territory of a State
- Similarly, offshore exploration may not constitute the “furnishing of services ... within a Contracting State” ¹³

Continental shelf

- This is why many coastal States extend the definition of their territory in their tax treaties so as to have Art. 5 and 7 apply to operations on the continental shelf
- Example (Norway-United Kingdom treaty)
“the term “United Kingdom” means Great Britain and Northern Ireland, including any area outside the territorial sea of the United Kingdom designated under its laws concerning the Continental Shelf and in accordance with international law as an area within which the rights of the United Kingdom with respect to the sea bed and subsoil and their natural resources may be exercised”

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Conclusion

- Thus profits from mining or oil/gas production are taxable in the State of source through a combination of Art. 6 (in the case of payments made by the enterprise that operates the mine or well to the owner/possessor of the extraction rights) and Art. 7 (in the case of the extracting activities themselves)
- The minerals, oil or gas, once extracted, constitute movable property
- If these are sold locally and the sale is attributable to the mine or to another PE in that State, the revenues from these sales are attributed to the PE
- If these are sold abroad, Art. 7(2) will require a notional sale from the PE to the head office or foreign PE of the enterprise that operates the mine

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Example of mining operations through PE

- RCO, a company resident of State R, has acquired from State S the right to extract minerals from a mine situated in State S
- In exchange for that right, it must pay resource royalties to State S
- RCO builds and operates the mine
- Once the minerals are extracted, they are shipped to State R where they are sold to independent processing companies by the head office RCO

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Analysis under the R-S treaty

- The mine constitutes a PE in State S; the profits from mining are therefore taxable in State S
- Since the resource royalties paid by RCo are paid to the government of State S, State S probably does not tax them (if these royalties were paid by RCo to a non-resident taxable person, such royalties would be taxable in State S under Art. 6(1))
- Under Art. 7(3) UN Model, the PE cannot claim a deduction for a “notional” resource royalty payable by the PE to the head office but may deduct real expenses, i.e. the royalties actually paid to the government of State S

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Analysis under the R-S treaty

- When the extracted minerals are transferred to the head office in State R, the PE should consider that there has been a “notional sale” from the PE to the head office at a price that is equivalent to what an independent distributor of extracted minerals would have paid
- This notional sales amount will constitute the revenues of the PE for the purposes of Art. 7(2); its expenses will be the royalties paid to State S plus the expenses of operating the mine

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PE issues related to the exploration and extraction of natural resources

- A number of bilateral treaties include special provisions that deal with perceived problems related to the application of the PE concept to the exploration /extraction of natural resources
- Some of these problems are:
 - The fact that the exclusive economic zone is not part of the territory of a State (see previous slides)
 - Unlike extraction activities, exploration activities often take place in different places, none of which constitutes a PE under Art. 5(1)
 - The fact that large scale mining and oil and gas operations may involve the use of a number of subcontractors that will provide services or expensive equipment and that will not have a PE in the State
 - The fact that some offshore activities might involve a presence in both States

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Example of special treaty provisions

[Australia-New Zealand]

Article 5 Permanent Establishment

2. The term “permanent establishment” includes especially: ...
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; ...
4. Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State: ...
 - b) carries on activities (including the operation of substantial equipment) in the other State in the exploration for or exploitation of natural resources or standing timber situated in that other State for a period or periods exceeding in the aggregate 90 days in any twelve month period; or ...such activities shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless the activities are limited to those mentioned in paragraph 7 which, if exercised through a fixed place of business, would not make this place of business a permanent establishment under the provisions of that paragraph

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Example of special treaty provisions

[Australia-New Zealand]
Article 6 (cont.)

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated and includes:
 - a) any natural resources, property accessory to real property, rights to which the provisions of general law respecting real property apply, and rights to standing timber
 - b) a lease of land and any other interest in or over land, whether improved or not, including a right to explore for natural resources, and a right to exploit those resources; and
 - c) a right to receive variable or fixed payments either as consideration for or in respect of the exploitation of, or for the right to explore for or exploit, natural resources
- Ships, boats and aircraft shall not be regarded as real property
3. Any interest or right referred to in paragraph 2 shall be regarded as situated where the land, natural resources or standing timber, as the case may be, are situated or where the exploration may take place.

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Example of special treaty provisions

CANADA-MADAGASCAR

Article 5
Permanent Establishment

2. The term "permanent establishment" includes especially: ...
 - f) a mine, an oil or gas well, a quarry or any other place relating to the **exploration for or** the exploitation of natural resources.

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Example of special treaty provisions

UNITED KINGDOM- NORWAY

Article 21
Miscellaneous rules applicable to certain offshore activities

1. The provisions of this Article shall apply notwithstanding any other provision of this Convention.
2. In this Article the term "offshore activities" means activities which are carried on offshore in a Contracting State in connection with the exploration or exploitation of the seabed and subsoil and their natural resources situated in that State.
3. An enterprise of a Contracting State which carries on offshore activities in the other Contracting State shall, subject to paragraphs 4 and 5 be deemed to be carrying on business in that other State through a permanent establishment situated therein.

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Example of special treaty provisions

UNITED KINGDOM- NORWAY

Article 21
Miscellaneous rules applicable to certain offshore activities

1. The provisions of this Article shall apply notwithstanding any other provision of this Convention.
2. In this Article the term "offshore activities" means activities which are carried on offshore in a Contracting State in connection with the exploration or exploitation of the seabed and subsoil and their natural resources situated in that State.
3. An enterprise of a Contracting State which carries on offshore activities in the other Contracting State shall, subject to paragraphs 4 and 5 be deemed to be carrying on business in that other State through a permanent establishment situated therein.

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Example of special treaty provisions

4. The provisions of paragraph 3 shall not apply
- a) where the offshore activities are carried on in the other Contracting State for a period or periods not exceeding in the aggregate 30 days in any twelve month period. For the purposes of this sub-paragraph:
 - (i) where an enterprise of a Contracting State carrying on offshore activities in the other Contracting State is associated with another enterprise carrying on substantially similar offshore activities there, the former enterprise shall be deemed to be carrying on all such activities of the latter enterprise, with the exception of activities which are carried on at the same time as its own activities;
 - (ii) an enterprise shall be regarded as associated with another enterprise if one participates directly or indirectly in the management, control or capital of the other or if the same person or persons participate directly or indirectly in the management, control or capital of both enterprises;
 - b) to production activities to which the provisions of Article 22 apply.

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Example of special treaty provisions

5. Profits derived by a resident of a Contracting State from the operation, in connection with offshore activities, of ships or aircraft which are in their existing state designed primarily for the purpose of transporting supplies or personnel, or for towing or anchor handling, shall be taxable only in that State. However, the provisions of this paragraph shall not apply to profits derived during any period in which such a ship or aircraft is contracted to be used mainly for purposes other than to transport supplies or personnel to or between places where offshore activities are being carried on, or for purposes other than towing or anchor handling, as the case may be.

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Example of special treaty provisions

- 6.a) Subject to sub-paragraph b), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment connected with offshore activities in the other Contracting State may, to the extent that the duties are performed offshore in that other State, be taxed in that other State.
- b) Where paragraph 5 applies to the profits from the operation of a ship or aircraft, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment exercised aboard that ship or aircraft shall be taxable only in the Contracting State of which the person deriving those profits is a resident.

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Example of special treaty provisions

7. Gains derived by a resident of a Contracting State from the alienation of:
- a) exploration or exploitation rights; or
 - b) property situated in the other Contracting State and used in connection with offshore activities, as defined in paragraph 2, carried on in that other State; or
 - c) shares deriving their value or the greater part of their value directly or indirectly from such rights or such property or from such rights and such property taken together;
- may be taxed in that other State. In this paragraph "exploration or exploitation rights" means rights to assets to be produced by the exploration or exploitation of the seabed and subsoil and their natural resources in the other Contracting State, including rights to interests in or to the benefit of such assets.

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Example of special treaty provisions

Article 22

Transmedian line oil and gas fields

1. The provisions of this Article shall apply notwithstanding any other provisions of this Convention where the Governments of the two Contracting States have entered into an Agreement relating to the joint exploitation of a field which extends across the dividing line and that Agreement expressly provides for the application of these provisions.
2. Irrespective of where the production installations for a field are located, a Contracting State may, subject to paragraph 3, tax, in accordance with the laws of that State, profits from the exploitation of the field which arise to a licensee of that State and shall not tax any such profits which arise to a licensee of the other Contracting State.

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Thank you

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