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Taxation of Gains on Transfers of Assets

CHALLENGES IN DETERMINING THE TAX BASE FOR EXTRACTIVE INDUSTRIES
ISSUES, PROBLEMS AND PRACTICE IN THE ANDEAN REGION

Bogota: September 29, 2015

Overview

- Importance of the issue – big transactions, big money
- Is this about economics or politics?
- Direct and indirect transfers
- The indirect transfer problem
- If a country decides to tax, what are its options?
- Consider extractive industry taxation, but applicable more widely – especially to assets that are grants of exclusive rights by public authorities.

Big transactions

- International tax hits international agenda: G7/8, OECD/G20 BEPS Project
- Uganda: Tullow acquisition from Heritage ($1.5 bn) - oil
- India: Vodafone acquisition from Hutchinson ($11.1 bn) – telecommunications
- Issues of domestic tax law and bilateral tax treaties
- Very high profile because the issue involves public resources or rights in developing countries.
- Special challenge now that commodity prices have fallen and company takeovers become more frequent.

Economics or politics?

- Strong argument that efficiency in capital allocation requires ease of corporate reorganization
- If a resource right is paid for by bonus bidding or an efficient rent tax, is taxing gains on transfers a variety of double taxation? Understood to be exempt in Norway, subject to conditions
- BUT if the expected return to the host in tax and royalty is too low, may be an economic argument for taxing gains
- Recent events show that it’s not politically tolerable to have large untaxed transactions in rights to a country’s resources occurring
- Effective taxation of gains may be a shift in timing of receipts that addresses both economic and political concerns.

Direct and indirect transfers

- Direct transfer: transfer whole or part of right itself
- Indirect transfer: owner of entity holding the right may transfer interest in the entity

Direct Transfer

- Allocate consideration across tangible and intangible assets transferred, including mineral right itself – a significant part probably to the right itself
- Treatment of any gain on disposal of mineral right depends on interplay of:
  - Rules for taxing business income (or gains)
  - Depreciation recapture rules (and what is carried forward as a loss)
  - Any applicable Tax Treaty
- The amount included in the income of a transferor should be the consideration received - reduced by the undeducted cost of the transferred right
- The transferee is entitled to deduct the consideration paid for the right (there is a step up in cost) – rules differ on treatment of deduction
- What happens to intangible expenditure (drilling) if not deducted before production – treat as a notional asset with a loss equal to the available deduction

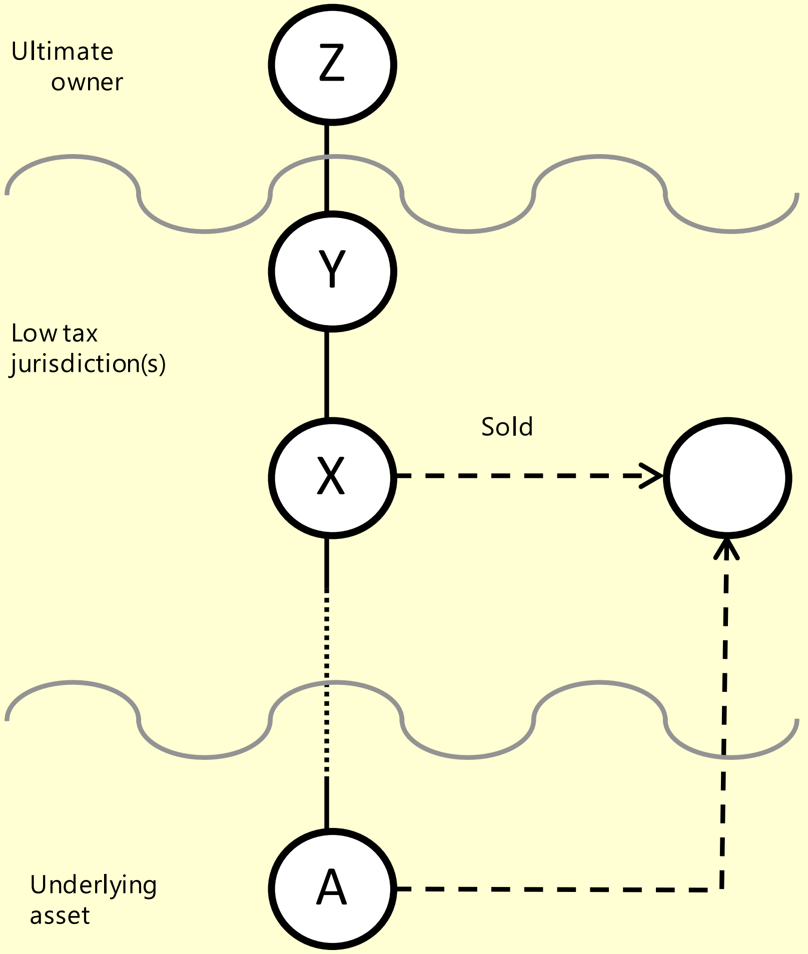
Farm Outs

- Bring in partner or particular expertise
- Transfer part of interest in return for work on original holder’s behalf
- Immediate or when work commitments fulfilled
- Treatment of any cash amount
- Treatment of future work commitments – simplest is possibly to exclude from income and not treat as consideration for transfer

Indirect Transfers of Interest

- Shares (or venture interests) derive their value from assets held by the entity – may include mineral rights
- If direct transfers are taxed, non-taxation of indirect transfers creates a tax planning opportunity
- What is the source of the gain?
- Is the gain included in business income?
- If the gain is taxed what is the treatment of the premium paid?

Indirect Transfers of Interest



What can be done?

- Ensure a broad definition of real property, and the right to tax gains on transactions in companies that directly or indirectly hold real property in the host country
- Need specific reference to indirect transfers of interest to include mining and petroleum rights and information in the definition of immovable property for income tax purposes.
- Include a reporting mechanism under which the relevant Ministry informs the Revenue Authority of any substantial change in ownership of contractors or rights-holders.
- Deem the local entity to be agent of the non-resident for payment of the tax due in respect of an indirect transfer of interest.
- OR deem the local company to have made the transfer?
- Need to ensure that treaties do not over-rule.
- Some countries retain non-final withholding as a prepayment of the tax payable on the gain.