



Getting it right in foreign lands

In order to understand the differences between different fiscal systems, it is necessary to understand the definitions of different legislations. The fiscal regime negotiated at the outset can determine enormous gains or losses of resource rent to both the foreign direct investor and the host state. It is important to get it right.

- **Resource legislation** means all legislation specifically designed for the purpose of regulating resource operations, such as construction and operation of resource installations including pipelines, and the health and safety of workers. It includes legislation concerning the imposition of any specific or special charges or duties on resource revenues, such as royalties, or any sharing of resource profits and any legislation specifically imposing the tax on income realised from resource operations. It also covers licences and contracts.

Resource legislation operates in conjunction with the relevant legislation and the fiscal legislation.

- **Relevant legislation** means all legislation other than resource legislation that is relevant for the conduct of resource operations and includes legislation concerning the conservation and the protection of living and non-living natural resources and environment; and legislation concerning the occupation, use and restoration of surface areas. Relevant legislation is administered by the government ministries and by provincial and municipal authorities or administrations. Of particular note here is that Investment Legislation, Customs and Competition Law [US Antitrust Law and Article 82 EC Treaty], (in particular, Third Party Access to Essential Facilities such as pipeline, port and rail networks: see Robe River and Fortescue Metals), should also be categorised as Relevant.

- **Fiscal legislation** means all generally applicable legislation concerning taxes on income and other taxes. Resource legislation may restrict the application and scope of the fiscal legislation as far as resource revenues or resource income are concerned and in this context may provide for exemptions, special tariffs etc.

Authorisations under resource legislation or relevant legislation permitting a licence holder or contractor to undertake resource operations becomes meaningless if fiscal legislation does not allow profitable outcome of these operations.

Resource legislation consists of:

- **Basic law** (Acts or decisions of a body of people's representatives);
- **Subsidiary legislation** emanating from government pursuant to its power under the basic law and referred to as regulations; and
- **Specific ministerial decisions** taken by a government minister pursuant to the regulations, which *inter alia*, may concern the award of the licences or the approval of the contracts. This is not limited to the developing

world (see the example of Cazaly Resources Ltd).

Separately there may exist a resource income tax law, containing the rules for a tax specifically designed to be imposed on income generated from resource operations. Such a resource income tax law operates in conjunction with the generally applicable or common income tax law.

Taxation: Generally a contractor or licensee is subject to any law that imposes tax on income or profit. In most cases this is the common income tax law, but it could be a special resource income tax law or even a special levy on profits imposed under the contract.

Under some types of contract (as applicable in Egypt and Syria) the income tax, for which the contractor is liable, is paid by the state enterprise on behalf of the contractor. This construction is important for the tax position of a foreign contractor in the home country.

Under other types of contract (as applicable in Libya) the contractor is exempted from paying income tax. This construction, however, brings a foreign contractor into difficulty in relation to the fiscal laws of his home country, resulting in having to pay income tax in the home country with a respect to income earned under the contract.

Stability: The issue of the stability of terms is a very important one for any investor in resource operations.

There are two methods to achieve the desired stability of the payments to the state:

- The rate of income tax is frozen, or
- The contractual payments, such as the sharing of profit resource, are adjusted to cancel the negative effects on the profitability of a change of the income tax.

Applying the first method, a contract should provide that the income tax will be levied at the rate existing on the effective date of the contract. Future changes to the rate of the income tax would then not affect the Government's take derived from the contract.

It has been mentioned in earlier articles that this is achieved by means of a stabilisation clause.

Resource taxation: In this context the special income tax may be deductible as a cost in calculating the taxable income under the rules of the common income tax, or, it may be the other way around. It may also be ruled that the special tax has to be paid in addition to, and independently from the common tax. In other cases a common tax is entirely replaced by a special tax, so that only a single tax on resource income is payable. In some instances a financial arrangement is made with the licensee, in accordance to which the implementation of a special income tax is modified so as to guarantee the tax paying licensee, in fiscal terms, a minimum profit after tax, the so-called fiscal margin.

As far as a state net profit share is concerned, the payment of such share generally qualifies for being allowed as a deduction from taxable income under common tax rules. The same applies to any royalty or other charges or duty that has to be paid.

The state gross profit share is to all intents and purposes the same as a special resource income tax, which is being levied in replacement of the common tax. In cases where such profit share is applicable, a common tax is considered as a pre-payment of the share. A complication arises in that, according to the rules of the common tax, the payment of the state profit share may itself be deducted as a cost in calculating the taxable income under these rules.

The following taxes and profit sharing arrangement may be applied:

- **Common income tax**, imposed under the general applicable income tax laws, calculated as a percentage of the taxable income.

It should be noted that in some cases, income tax is replaced by production-sharing, whereas, in other cases it may be added in a number of ways;

- **Special resource income taxes**, imposed on income derived from resource operations by a special resource income tax law, calculated as a percentage of the taxable income.

- **Additional profit tax**, which is a tax calculated as a percentage of the annual cash surplus, and payable after payout (cumulative cash in exceeding cumulative cash out) has been reached.

Additional profit taxes are sometimes in lieu of all other taxes.

- **State net profit share**, which amounts to a percentage share of the net profit (profit after income-tax) realised by tax paying resource enterprise.

The rules of calculation of the state net profit share will be laid down in the regulations or the licence.

- **State gross profit share**, which amounts to a percentage share of the gross profit (revenues minus deductible costs) realised by a tax paying resource enterprise.

Such payment is in itself a deductible item in determining taxable income under the common income tax;

- **Royalty**, which is a tax calculated as a percentage of the value of the resource production and levied and assessed at the wellhead/mine or at point of sale, sometimes payable in kind.

The important elements in the calculation of royalty are the rate, the place where the value is assessed and the base value. As a rule a theoretical arm's length market value is taken as the base value. If the wellhead or mine is selected as the place of assessment, all capital and operating cost involved in treating, handling and transporting the resource from the mine or wellhead to the marketplace