Submission on Proposed Timor-Leste JPDA Taxation Regime

Principal Issues

1. Limitation on Tax Deductions

Article 9.2 of the Timor-Leste Petroleum Taxation Act 2004 (the "Act") disallows tax deductions for costs which are "disallowed" as recoverable under the PSC. Non-recoverable costs include (amongst others) interest (except in special cases) and foreign exchange costs. Is it intended that interest and foreign exchange costs would only be allowed as tax deductions if allowed as recoverable under the PSC? Does this conflict with Article 8 which deals with interest deductibility?

2. Interest Deductions

Further to the fundamental issue of general interest deductibility described above, section 43-24.1 of the Regulation imposes a restriction on interest deductions which may significantly impact the commercial returns and viability of projects. This restriction is more severe where the modification imposed by section 8 of the Act applies.

The interest deduction restriction on Timor Sea operations raises the following issues:

- Interest capitalized prior to commencement of commercial production would generally be expensed through depreciation over the lifetime of the corresponding asset. The proposed rule that interest can only be carried forward for 5 years creates uncertainty in relation to the future deductibility of capitalized interest.
- Oil and gas projects require substantial funding, and the revenue generated can fluctuate significantly depending on market forces. We submit that in this situation rules for deductibility of expenses should be more flexible. This has been recognized in the Act with respect to provision for an indefinite tax loss carry forward period. A similar rule granting unrestricted deductibility is in our view justified for interest.
- This rule creates additional complexity and risk for taxpayers/investors.

As an alternative, we recommend implementing a standard, simple thin capitalization rule that would have the effect of limiting the level of debt funding to a reasonable threshold

3. Basis of Accounting – Instalment Income

Section 43-20.6 implies that revenue that is receivable in installments is treated as entirely received by the taxpayer on receipt of the first installment. This provision may be interpreted unfairly and there does not appear to be any reason to depart from the accounting rules in relation to rentals, subscriptions, leases and the like. It should be noted that as regards expense recognition (Sections 43-20.8) the costs are recognized on a time basis.

4. Commencement and Scope of Application of New Regime and Interaction with Present Taxation Arrangements

The Act

We note that the Act applies to years commencing on or after 1 January 2005, and does not apply to PSC areas 03-12, 03-13, 03-19, and 03-20 (which include Bayu-Undan, EKKN and Sunrise projects).

The Regulation

The proposed Chapter VIIIA of the Regulation applies to years commencing "on or after 1 January 2003" (per title) and "1 January 2004" (per section 43.1) which in either case would appear to be retro-active in nature. This retro-activity is likely to create problems for compliance by taxpayers as well as the Timor-Leste Revenue Service.

We note that the scope of the Regulation is also different as it excludes only Bayu-Undan and would therefore appear to apply retrospectively to EKKN and any other future projects within PSCs 03-12 and 03-13. Is this intended?

Interaction of new Timor Sea Tax Regime with the Domestic Tax Regime and status of UNTAET Regulation 1999/1

Interaction of the Regulation with the *Law on Income Tax* pursuant to UNTAET regulation No. 1999/1 is not clear. Article 4 of the Act makes contractors and sub-contractors subject to "tax" in accordance with 2000/18 as modified by the Act. The extent of residual application of the *Law on Income Tax* is unclear. This uncertainty creates difficulty in determining and interpreting the taxation regime.

One example of this is the taxation of wages for services performed in the Timor Sea. The Regulation exempts "*wages* received in the territory covered by the *Timor Sea Treaty*" from wages tax. How are such wages intended to be taxed – or is the *Law on Income Tax* pursuant to UNTAET regulation No. 1999/1 intended to apply?

If the *Law on Income Tax* pursuant to UNTAET regulation No. 1999/1 is effectively repealed then does this mean that all related regulations, rulings, decrees, elucidations and interpretations of laws, private ruling letters etc also cease to be part of the taxation regime pursuant to the Regulation? If so, how would the removal of such precedence and interpretive material be redressed in order to provide certainty and stability for the tax regime?

Resulting Complexity

This illustrates the complexity that is emerging in the taxation of JPDA projects. As proposed there would be three different tax regimes – Bayu-Undan, Annex F PSCs (excluding Bayu-Undan), and other PSCs. In the event future projects negotiated special terms there would be a further addition to the complexity of taxation arrangements. The complexity of taxation arrangements would also increase if some projects negotiate tax stability agreements in an environment where the general tax regime continues to change and evolve significantly over time.

The administrative costs of operating in an area subjected to multiple taxation regimes will be particularly burdensome for investors and contractors providing shared services or projects with shared infrastructure. This complexity will also affect the efficiency and cost of tax administration.

This complexity would be avoided if the Taxation of Bayu-Undan Contractors Act were extended in application to the entire JPDA, with the only changes being to enhance transparency and certainty. Timor-Leste is already committed to administering this tax regime for the duration of that project. Special terms for specific projects could then be limited to isolated matters such as PSCs, rates of tax depreciation and threshold for additional profits tax in order to balance the economic requirements of Timor-Leste and the investors whilst maintaining a fundamentally consistent tax regime for the whole JPDA.

Other Issues

5. Limitation on Losses and Tax Deductions

Article 7.1 of the Timor-Leste Petroleum Taxation Act 2004 (the "Act") limits deductions to those relating to a specific contract area. This prevents exploration deductions from an unsuccessful area from being used in another area. Whilst this is consistent with the historical regime this reduces exploration incentive to the region as a whole.

Carry-forward losses appear to have an indefinite carry-forward due to the application of Article 7.3 of the Act which defers excess deductions to the next year. The *Law on Income Tax* contains a 5-year expiry period. Please clarify that this does not retain a residual affect on the ability to utilise excess tax deductions.

Article 9.1 creates a special limitation of head office expenditure to 2% of other deductible expenditures for Timor Sea operations. In early years when a majority of costs are capitalised, this artificial rule could result in significant head office costs being non-deductible especially if it applies to head office costs capitalised. Additionally, this article may have the effect of distorting classification of costs and driving decisions about where to locate certain activities. For example if activities are performed within the branch office of permanent establishment ("PE"), they may be deductible but if performed externally, at the head office, then they may be disallowed. This rule opens up the potential for differing interpretations by the Revenue Authorities and Taxpayers. What is the rationale for disallowing "head office" costs as tax deductions when they are directly associated with the operations of the PE?

Non-deductibility of genuine PE business costs is likely to result in double taxation/increased effective taxation rates. For example, an Australian company that spends $100 on head office costs will only be able to claim $10 in Australia pursuant to the Treaty. If it is limited to less than the full $90 deduction in Timor-Leste ($100 x 90%) then it is effectively subjected to a double tax to extent of the tax on the short-fall.

6. Branch Profits Tax

The Act does not appear to explicitly repeal or remove Branch Profits Tax (or "BPT" - per Article 26(4) of the *Law on Income Tax)*. The TLRS have verbally indicated that BPT is NOT intended to apply, however, the mechanism for removing BPT is not clear. However we note that this point relates to the issue raised at point 4 above.

7. Alternative Minimum Tax

The Regulation contains a "Minimum income tax" pursuant to section 43-5. If this applies a taxpayer may incur an income tax cost in a year in which a tax loss is incurred. This may reduce or eliminate the value of tax losses and accelerated tax depreciation and result in an increase the effective income tax rate applicable to a project. (This appears to be the same as the alternative "Minimum Tax" in section 36A applicable to non-Timor Sea business operations of earlier years).

8. VAT

Article 5 does not clarify or confirm the application of VAT with respect to its' non-application to goods, limitation to services activities carried out within the JPDA and also regarding administration (i.e. who collects and pays). We would like to see these matters clarified.

9. Tax Depreciation

Article 11.5 of the Act is arbitrary and could conceivably result in significant or indefinite deferral in the commencement of tax depreciation. The uncertainty created by this provision and the potential for deferral counter-acts the intent and purpose of accelerated depreciation benefits.

If the intent is to provide a deferral on the start date for tax depreciation then this should be provided in a transparent manner that provides certainty so that investors can determine the implications for investment decisions.

10. Transfer of PSC

The intent of Article 13 of the Act is unclear. Is it merely intended to ensure the tax classification of costs, remaining depreciable life of assets etc, is retained or is it intended to that the purchaser inherits the tax basis of the vendor (i.e. without regard to the actual purchase price). If the latter is intended, what happens to the gains and losses on a sale transaction? – presumably these would be ignored; however this outcome is not addressed in the Act.

11. Petroleum Valuation – Transfer Pricing

Article 14.2 creates uncertainty and is in our view unnecessary given the presence of "arms-length" and anti-avoidance rules in the Regulation (see sections 43-9.5, 43-31.2, 91 and 93). Terms such as "fair and reasonable" are ambiguous.

12. Withholding Taxes

Article 15.1 appears to impose a 5% increase on all capital costs – if so, this would result in a substantial increase in the capital cost of undertaking a project. Furthermore, this tax may cascade and multiply through subcontractors and may distort the selection of contractors for particular works due to the legal structure of contractors.

This appears to be an extra-jurisdictional tax that would apply even in the case where work is performed or goods constructed/acquired in other countries. In this case it would not be possible to claim a foreign tax credit for Timor-Leste tax imposed and this would result in double taxation costs to investors.

It is also unclear how this provision relates to the source rule in the Timor Sea Treaty Tax Code and these issues create additional uncertainty and cost exposures.

Additional costs and risks would be factored into the evaluation of exploration prospects possibly resulting in less exploration activity than would otherwise occur.

We also question how this provision could be enforced in respect of payments made by non-residents with no PE in Timor-Leste? It is unclear how this provision interacts with the PE principle.

With respect to section 43-7 of the Regulation, we understand that international transport providers engaged as suppliers for petroleum operations would be subject to 5% final withholding tax, instead of this 10% final tax pursuant to the Act. Nevertheless, it is a concern that such a high tax will increase the cost of all imported goods into Timor-Leste, which will have an indirect impact on petroleum contractors.

Furthermore, this will further complicate the "shared service" (e.g. helicopters and workboats) problem that already exists in relation to flights that cross multiple tax jurisdictions. For example, a helicopter leaves Darwin, flies to Bayu-Undan, also carrying goods for Elang and the Bayu-Undan pipeline contractor before flying to Dili. The taxation of such a flight is complicated enough before adding a different tax rule for international traffic with mainland Timor-Leste.

We propose that:

- the wording be clarified to ensure the tax is subject to a source rule similar to that stated in the Timor Sea Treaty, and does not in effect apply extra-jurisdictionally;
- the wording be clarified to ensure the tax cannot cascade and only applies in the first instance to the payment from the PSC contractor to their sub-contractor; and
- a scale of rates be applied dependent on the type of services so as to more reasonably reflect industry standards regarding profit margins, such as presently exists for Bayu-Undan. We cannot see the justification for application of a flat rate as compared to the scale of rates that exists under the Regulation. Alternatively, the tax could be final in limited circumstances with PEs being taxed on actual profits in most cases or having the option of opting whether the tax is final or non-final (a prepayment).

13. Bad Debts

Section 43-16 allows bad debt as a deduction in a tax year, provided that all conditions stipulated in this section is fulfilled. However, the section would not appear to cover the following legitimate debt write off situations:

- Deduction in the event of an agreed settlement. In our experience, write-offs of receivables in a contracting situation usually arise as a result of contract disputes, rather than an inability to pay. Such losses should not be excluded as valid deductibles.
- Deductions of write-offs are restricted to amounts previously included in "income". This may mean that there would be no tax deduction for write-offs related to loans. (The cancellation of liability on the other hand is considered to be taxable income.)
- Up-front payment and retentions may be considered "balance sheet" amounts that are not directly included as income. A loss relating to write off of such amounts should still conceptually be on revenue account.

14. Alienation of Assets

Please clarify the operation of section 43-4.1 (f) in relation to taxation of gains from alienation of property. Is it intended that a gain on disposal of shares in an Australian company that owns property in Timor-Leste would be subject to Timor-Leste taxation? If so, how is double taxation relieved where, for example, such a gain is fully subject to Australian tax (being in relation to the disposal of an Australian asset being shares)? If a tax loss is incurred rather than a gain will the tax loss be recognised in Timor-Leste?

15. Tax Collection and Administration

Article 16 in its entirety is an onerous obligation to produce 4 detailed estimates of tax payable per year with substantial penalties for shortfalls. In Article 16.6(b), an interest penalty would be a fairer approach.

We also note that the present tax return lodgement deadline of 31 March is in our experience difficult to meet (a matter we have raised informally on numerous occasions). The proposed Regulation exacerbates this issue by bringing forward the tax return deadline to 15 March. We request that consideration be given to extending the statutory period for lodgement of annual returns to May or June.

16. Tax Refunds

The proposed addition of section 54A to the Regulation appears to empower the Commissioner to arbitrarily withhold payment of refunds indefinitely. This is alarming. The only limitation provided to this power is in the case where the taxpayers business has terminated.

Pursuant to section 51.8 the Commissioner is required to pay interest on overpaid taxes. If a section such as 54A is to be included we submit that:

- it should be clarified that the Commissioner must pay interest on the outstanding balance for the period the refund is withheld;

- the interest rate prescribed must be fair and set in a transparent and independent manner; and
- the period of time for which the Commissioner can withhold payment must be limited (say in relation to tax obligations for the current tax year only).

17. Supplemental Petroleum Tax

Article 21.2 of the Act has the effect of deferring the uplift on any deductible expenditure contributing to an income tax loss until the year in which the loss is allowed as an income tax deduction. This is not consistent with the conceptual approach of the supplemental Petroleum Tax which is basically a super-profits tax which should be calculated based on cash flows.