

# COMPLIANCE AND DISPUTE RESOLUTION IN THE EXTRACTIVE SECTOR

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**MANAGING FISCAL REGIMES, TAX COMPLIANCE AND DISPUTES IN THE OIL, GAS  
AND MINING SECTOR**

**BY**

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# MANAGING FISCAL REGIMES

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**Fiscal regimes comprise of laws, taxes, royalties, contracts and agreements which define rights and obligations between the Government and investors and how revenues from natural resources are shared between them. This is a policy issue that shapes the choice of the type of fiscal regime to have in place.**

# CHOICES OF FISCAL REGIMES

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- The common types of fiscal regimes are:
- Concessionary systems where ownership vests with the investor. This used to be most common in the mining sector. In this regime the investor is responsible for the financing of the mining project, but often after obtaining Government commitment to support the development through extensive tax incentives and which are freely given. The Government incurs heavy costs in the form of tax expenditures but without equity entitlement. In return, the Government is to receive royalties and corporate taxes.
- Experience shows that the attendant agreements which govern the relations between the Government and the investor may be cockeyed and cause Governments to be on perennial loss position. In Tanzania, the example are the Mining Development Agreements (MDAs) previously used. They contained unrestricted loss carryovers, expensing of royalties, rights to offset expenditure from loss making mining operations against profitable operations (cf. ringfencing), 100% deductibility of capital expenditure (including capitalized exploration expenditure), royalties calculated on netback value, right to export raw minerals without beneficiation, retention of earnings from mineral sales abroad (cf. capital repatriation), choice of source of procurement (cf. local content rules), unregulated transfer pricing/base erosion/profit shifting, and many other inimical practices.
- This type of regime does not respect the rule on permanent sovereignty over natural resources and has led to unending conflicts between investors and national governments.
- Today modified concessionary systems are in use whereby resident joint ventures between the Government and investors are preferred and which ensure that the two sides are equity holders and the mineral rights are jointly owned through the JVC arrangement. Safeguards are in place to ensure that profitability of mining operations is not syphoned off through transfer pricing, base erosion and profit shifting, unmitigated capital repatriation, lifetime tax incentives, mineral beneficiation within the country, local content requirements, and other safeguards. The concession no longer means total ownership by investors with total discretion over the minerals and profits.

# CHOICES OF FISCAL REGIMES CONT...

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- **Production Sharing Agreements (PSAs)** which have evolved over a long period. The PSA arrangement basically recognizes and acknowledges that the natural resource is the property of the country where it is found. In the case of a developing country, especially in Africa, financing the development of the resource is very challenging. Almost all the capable financing institutions are located in the developed western countries. It becomes unavoidable to use the intermediation of the foreign western investors to access the required project financing. Hence, the partnership brought about under PSAs.
- The underlying assumption is that the owner-country has the resource but without neither knowhow and ability to access financing, nor efficient access to the foreign dominated and controlled market. The foreign investor has access to financing institutions and the world market. Usually the foreign investor is one or a consortium of the international oil companies (IOCs).
- PSA is an arrangement whereby the two sides join hands to extract the resource by sharing the costs of production and the profits. In a typical arrangement, once project financing is secured and production commenced, an agreed proportion of the oil or gas is firstly appropriated to offset the cost of production (Cost gas). Another portion is for sharing (Profit gas). In addition the venture pays royalty to the Government before any cost gas is provided for. The Government enjoys its share free of tax while the investor pays corporation tax on the profit gas allocated/received.
- Mr. Killagane has a detailed outline of how PSA has worked in Tanzania. A powerpoint presentation is appended.

# CHOICES OF FISCAL REGIMES CONT...

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- Service contracts or hybrids are arrangements whereby the Government retains ownership of the resource but hires an operator to perform specific exploration or production tasks for a fee. Service contracts may either be Risk Service Contracts (RSC) or Pure Service Contracts (PSC).
- RSCs are where the Contractor assumes all financial and operational risks during exploration and production. If successful they are paid a fee either in cash or a portion of the produced gas/oil. The fee is subject to income tax.
- PSCs are where the Government funds the exploration and development phases. The Contractor is simply paid a flat, agreed upon fee for their technical services.
- Tanzania has not adopted the use of service contracts.

# MANAGEMENT OF FISCAL REGIMES

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- Fiscal regimes in the extractives and mining sectors require effective management to ensure the following:
- To capture a fair share for the state but ensure that the jurisdiction remains competitive and attractive to investors.
- Government take increases with profitability. For example by the use of sliding scales on production, price or IRR to handle windfalls and protect investors in low-price scenarios.
- Minimize distortions by using neutral instruments that do not discourage marginal investments.
- Manage risks such as price volatility, geological uncertainty, cost overruns, environmental or social factors.
- Ensure stability and transparency through clear laws that reduce discretion and corruption. Rather than use stabilization clauses it is also preferable to use review mechanisms.
- Prevent wasteful incentives, such as free and unregulated tax incentives
- Ring-fencing to prevent cross-subsidization

# CHALLENGES IN MANAGING FISCAL REGIMES

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- Fiscal regimes are susceptible to factors that may erode their efficacy or undermine their specific objectives/purposes. They therefore need to be attended to, in order to maintain their effectiveness.
- Several challenges may need to be managed as they arise.
- First is dealing with price volatility. Prices may swing upwards (windfall) or downwards (low-price scenarios). On the part of the Government buffers are needed in the form of fiscal rules or funds. Fiscal rules refer to long-lasting, self-imposed constraints on government policy that set numerical limits on public finances, such as debt, deficits or spending. These are used to prevent overspending, excessive borrowing and to ensure long term economic sustainability.
- Second is ability to combat tax avoidance/evasion. Complex fiscal regimes require strong administration and anti-avoidance rules.
- Third is stability and predictability. Investor confidence is eroded by frequent changes of laws.
- Fourth is to ensure continued relevance of regimes. It is desirable to institutionalize periodic reviews and have in place renegotiation clauses.

# TAX COMPLIANCE

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- Tax compliance is a civic obligation. It refers to the process by which taxpayers meet their legal obligations under tax laws.
- **Basic Assumptions Underlying Tax Compliance:**
- **(1) Certainty:** There is certainty in understanding the tax system and the tax laws. Tax obligations and liabilities are ascertainable in advance. No surprise element.
- **(2) Predicability:** It is possible to predict and plan for compliance with tax obligations before hand.
- **(3) Convenience:** It is convenient for taxpayers to discharge tax obligations without hardship.
- **(4) Guidance:** Availability of taxpayer support/services including published practice notes and easy of obtaining advance tax rulings
- **(5) Access to specialized experts e.g. tax consultants (accountants, lawyers and others like valuers and the like).** These are important in preparing requisite reports and record keeping.

# TAX COMPLIANCE CONT...

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- **Knowledge of Compliance Requirements:**
- (1) Identifying the applicable law, regulations and rules
- (2) Identifying the compliance obligations e.g. registrability, notices, returns and timelines for filing, amendment opportunities for documents/information furnished to tax authorities, certification of records e.t.c.
- (3) Knowing any special compliance requirements e.g.
  - - royalties & production based payments
  - - ring-fencing requirements
  - - transfer pricing rules, aggressive cost claims and use of tax havens
  - - beneficial ownership disclosures (check EITI Standards)
  - - decommissioning rules
  - - environmental responsibilities
  - - occupational liabilities
  - - cross-border transactions & double taxation
  - - BEPS (Base Erosion and Profit Shifting) rules
  - - loss carry forward limits

# TAX COMPLIANCE CONT...

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- **Organizing an Internal Tax Compliance System:**
- **Taxes, levies, duties, charges and other imposts are many and can be perplexing. Each have unique compliance requirements and at times different administering authorities. Often dedicated staff are needed to handle tax compliance. The following are important to consider:**
- **Corporate Tax Policy and Tax Control Framework. Underlying principles may include compliance-first, arm's length, transparency, anti-corruption e.t.c. The objective is to create a structured, proactive framework within a company to ensure adherence to tax laws, minimize risks, optimize obligations, and support overall fiscal regime management. In extractive industries this is very crucial due to complex fiscal terms, ring-fencing, transfer pricing, royalties, production sharing, EITI reporting and high scrutiny from tax authorities**
- **Governance: Having in place a dedicated Tax Compliance Officer with direct access to leadership; Creating a Compliance Committee which meet regularly to review risks and status.**
- **Conduct thorough risk assessment e.g.-**
  - **- identify key risks: related party transactions & transfer pricing rules, cost recovery/allowable deductions, royalties vs profit based taxes, withholding taxes, VAT on services, decommissioning liabilities and subcontract disclosures.**
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# TAX DISPUTES SETTLEMENT

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- **An Overview – The Tanzanian tax disputes system is defective because it is structured based on wrong assumptions. It is obsolete.**
- **Ideally when a taxpayer disagrees with the tax authority's decision (either on assessment, audit findings, penalties or other determinations regarding tax liability, then there is a tax dispute.**
- **Resolving a tax dispute involves administrative, negotiated or judicial processes guided by principles of fairness, legality and impartiality.**
- **Basic Assumptions in Tax Dispute Resolution**
- **First is that resolving a tax dispute is intended to support tax compliance. Tax disputes are very costly to both the taxpayer and the tax authority/Government. This is more so in the extractive and mining sectors where disputes involve huge amounts.**
- **Second is that tax decisions are made after effective consultations with legal experts. In Tanzania, often legal experts are brought in after the dispute has escalated to an impasse. The tax authority and the taxpayer have agreed to disagree.**
- **Third is that the tax decision has gone through effective administrative vetting, especially when it involves huge amounts, or it has policy connotations, or it is likely to raise public concerns, or it conflicts with socio-economic dictates or defeats a public objective. It means that the decision cannot come directly from a tax officer even if the law deems that the officer acts on behalf of the Commissioner General. All implications have to be considered at a higher level e.g. a special committee or administrative organ that is set up to oversee quality of tax decisions.**
- **Fourth is that litigation is a last resort. There is a fair and even-handed internal procedure for a collaborative resolution of a tax dispute**

# TAX DISPUTES SETTLEMENT CONT...

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- **Types of Tax Disputes:** Tax disputes may be purely based on point(s) of fact, or point(s) of law, or mixed point(s) of fact and law. [See Luoga's Paper on Resolution of Tax Disputes.]

# TAX DISPUTES SETTLEMENT CONT...

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- **Principles of Resolving Tax Disputes:**
- **(1) Fairness and Impartiality:** Disputes should be resolved based on facts, applicable law (statutes, regulations, precedents). **NB:** Independent review bodies help to ensure neutrality.
- **(2) Voluntary Compliance and Efficiency:** Objective is to settle without litigation.
- **(3) Transparency and Due Process:** Taxpayers receive notice of issues, explanations of decisions, and opportunity to present evidence/arguments. Deadlines and procedures are clearly defined.
- **(4) Proportionality and Hazards of Litigation:** Settlements may consider the relative strengths/weaknesses of positions, litigation risks and costs
- **(5) Separation of Roles:** Those involved in investigation or negotiating should differ from those approving final settlements.
- **(6) Even-Handedness and Expertise:** Resolutions should align with published guidance and involve appropriate tax experts for scrutiny and consistency
- **(7) Timeliness:** Processes aim for prompt resolution, with mechanisms like mediation or arbitration to avoid prolonged uncertainty

# TAX DISPUTES SETTLEMENT CONT...

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- **Stages in Resolving Tax Disputes:**
- **(1) Examination/Audit Stage:** Tax Authority reviews tax return and proposes adjustments. Taxpayer should provide documentation promptly. Many issues expected to be resolved at this stage. **NB:** If non-existent documents are demanded internal administrative intervention should be possible
- **(2) Administrative Appeal/Objection:** Tax Authority should maintain an independent office of appeals. An appeal/objection be handled independently with impartiality so that the dispute is settled based on law and facts without the court. This would resolve most disputes and may include other options like mediation or rapid resolution processes (e.g. case stated where the dispute solely hinges on a point of law)
- **(3) Alternative Dispute Resolution (ADR):** Fast track Settlement, mediation, Advance pricing agreements etc as provided under tax treaties
- **(4) Judicial Review:** This does not apply in Tanzania because of an unfortunate Court of Appeal Decision.
- **(5) Appeals to TRAB and TRAT**
- **(6) Appeals to the Court of Appeal**