Chapter IX (Taxes and Duties Act, 2008) REGULATIONS, 2012

Interpretation

Chapter I

Section 1
Preamble & Purposive interpretation & Short Title

Where Sections in the present Regulation are capable of alternative interpretations, the interpretation that best achieves the intended purpose of Chapter IX of the Taxes and Duties Act 2008 shall be adopted and any interpretation that frustrates the intended purpose of the legislation or impedes the right of Timor-Leste to collect the tax revenue accruing from Petroleum Operations in accordance with the applicable tax laws, including Treaties shall be rejected.

The present Regulations shall be referred to as Regulation TDA-IX/2012

Section 2
Definitions extend to other forms of words

2.1 Definitions in the present Regulations in the singular form shall be read as applying to the plural form and definitions in the plural form shall be read as applying to the singular form as appropriate.

2.2 Definitions in the present Regulations in the masculine form shall be read as applying to the feminine form and definitions in this section in the feminine form shall be read as applying to the masculine form.

Section 3
Scope of Regulations

The present Regulations shall apply to the territory of Timor-Leste, including its territorial sea, and to its exclusive economic zone and continental shelf where, by international law, Timor-Leste has sovereign rights for the purposes of exploration for and exploitation of its natural resources and applies to the Joint Petroleum Development Area, other than the area covered by the Production Sharing Contracts described in Annex F of the Timor Sea Treaty.

The present Regulations shall also apply only to a Contractor or Subcontractor, and any person receiving an amount for goods or services supplied to a Contractor or Subcontractor or by a Contractor or Subcontractor to any person in connection with Petroleum Operations in Timor-Leste, excluding the area designated as Annex F in the Timor Sea Treaty.

Section 4
Definitions

In the present Regulation:

"**Accounting**" means a systematic process under the IFRS or a Generally Accepted Accounting Practice, of recording of data and information in respect of assets, liabilities or debt, equity, income and expenditures, and all outlays associated with the acquisition and delivery of goods and services, resulting in a financial report in the form of a balance sheet and profit and loss statement at end of each reporting period

"**Affiliate**" means in respect of a Contractor or Subcontractor (or, if more than one person, in respect of each such person), a person that controls, is controlled by, or is under common control with the Contractor or Subcontractor or any such persons as the case may be;

"**Associate**" in relation to a person means any other person who acts or is likely to act in accordance with the wishes of the person as a result of a connection between the persons or common ownership or control; 3 of the UNTAET Regulation 2000/18; it includes:

a) A natural person and a relative of the natural person;
b) A legal person and any person who owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in the legal person; or
c) Two or more legal person if a third owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in each person;

"**Amount**" includes any value in kind or cash;

"**Air or Sea Transportation Services**" means any transportation of passengers, mail, or goods by air or sea:

a) between two places in Timor-Leste;
b) From a place in Timor-Leste to a place outside Timor-Leste;
c) From a place outside Timor-Leste to a place in Timor-Leste

"**Annual Tax Return**" means a form used by a taxpayer to report the calculation and/or payment of tax due within a tax year

"**Approval**" means a written authorization;

"**Approved Contract**" means a contract made by the Contractor and approved by the responsible Ministry or Designated Authority, as the case may be, as part of a Development Plan;

"**Arm's Length Transaction**" means transactions in which the conditions and or terms imposed between two related parties or associates in their commercial or financial relations are similar to those which would be made between independent enterprises;

"**Audit**" means a series of activities to seek, gather and process data, documents and or information for tax compliance purposes;

"**Bank**" means any legal person licensed to accept deposits, and using such funds, either in whole or in part, to make extensions of credit or investments for the account, and at the risk, of the person carrying on the business;

"**Board**" means the Board of Tax and Customs Appeals established under the UNTAET Regulation 2000/18;

"**Body**" means a type of business organization which may be a limited company, limited partnership, an enterprise owned by the government in whatever name and form, association, cooperative, joint venture or similar arrangement, permanent establishment and other such business enterprise;

"**Carry Forward Loss**" means a loss carried forward under Section 73 of the Taxes and Duties Act, 2005, excluding interest expense carryover under Section 74.3 of the Taxes and Duties Act;

"**Code**" means the Petroleum Mining Code agreed and adopted by Timor-Leste and Australia under Article 7 of the Timor Sea Treaty, as amended, varied, modified, or replaced from time to time, and the regulations or orders made thereunder;

"**Commissioner**" means the Commissioner or the Director General of the Directorate of Revenue and Customs of the Ministry of Finance Timor-Leste;

"**Contract Area**" means the area that is subject of a Petroleum Agreement and, if any part of a Contract Area is relinquished pursuant to a Petroleum Agreement, the Contract Area is the Contract Area originally granted;

"**Contractor**" means a person with whom the responsible Ministry or Designated Authority, as the case may be, has made a Petroleum Agreement;

"**Control**" means in relation to a person, the power of another person to secure:

a) by means of the holding of shares or the possession of voting power, in or in relation to the first person or any other person; or
b) by virtue of any power conferred by the articles of association of, or any other document regulating, the first person or any other person,

that the affairs of the first person are conducted in accordance with the wishes or directions of that other person;

'**Controlled Taxpayer**" means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers;

"**Controlled transaction or controlled transfer**" means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term uncontrolled transaction means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers;

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"**Crude Oil**" means crude mineral oil and all liquid hydrocarbons in their natural state or obtained from Natural Gas by condensation or extraction;

"**Customs Controller**" means the Controller of the *Customs Service*;

"**Customs Service**" means the Timor-Leste Customs Service;

"**Customs Value**" means the fair market value of the *goods* including cost, insurance and freight as determined in accordance with article VII of GATT, or any amendments thereunder;

"**Crude Oil**" means crude mineral oil and all liquid hydrocarbons in their natural state or obtained from Natural Gas by condensation or extraction;

"**Decommissioning Plan**" means the Decommissioning Plan approved the responsible Ministry or Designated Authority, as the case may be, under a Petroleum Agreement;

"**Decommissioning Security Agreement**" means the Decommissioning Security Agreement approved by the responsible Ministry or Designated Authority, as the case may be, under a Petroleum Agreement;

"Depreciable Asset" means any tangible movable property that:

(a) has a useful life exceeding one year;
(b) is likely to lose value as a result of wear and tear, exploitation, or obsolescence; and
(c) is wholly or partly or substantially used in the conduct of taxable activities;

"**Designated Authority**" means the Designated Authority established under Article 6 of the Timor Sea Treaty;

"**Designation Notice**" is a notice described in Section 68 of UNTAET Regulation 2000/18;

"**Development Expenditure**" means expenditure incurred, after the responsible Ministry or Designated Authority has approved a Development Plan, in preparing a site for Petroleum Operations, including drilling and completing production wells, and the construction of production facilities, but does not include any expenditure incurred in the acquisition or construction of a pipeline or in the acquisition of a depreciable asset;

"**Development Plan**" means the plan for the development and production of petroleum or gas resources in the Contract Area approved by the responsible Ministry or Designated Authority, as the case may be;

"**Dividend**" means any distribution of profit from current year or from accumulated earnings by a legal person to a member as a result of participation in the capital of the legal person, including:

a) Any amount returned to a member in respect of a membership interest in a legal person on a partial reduction in capital to the extent that the amount returned exceeds the amount or value by which the nominal value of the membership interest was reduced; or
b) Any amount distributed to a member on redemption or cancellation of a membership interest, including liquidation, to the extent the amount distributed exceeds the nominal value of the membership interest;

"**Employee**" means:

a) a natural person who is in employment; or
b) a natural person whose provision of services is substantially similar to the provision of services by a person who is in employment

"**Employer**" means a *person* who hires an employee pays periodic *wages* to an *employee*;

"**Employment in Timor-Leste**" means the provision of personal services in Timor-Leste:

(a) in the course of an *employer* and *employee* relationship;
(b) as director of a company;
(c) as the holder of a public office; or
(d) as an official of the government of Timor-Leste posted overseas;

"**Exploration Expenditure**" means expenditure relating to and connected with geological, geophysical and geochemical surveys, exploration or appraisal drilling, or feasibility and environmental impact studies incurred in conducting Petroleum Operations prior to the grant of an approval of the Development plan by the responsible Ministry or Designated Authority, as the case may be;

"**Field Export Point**" means the point at which petroleum from a Contract Area leaves the Contract Area, or such earlier point at which it is loaded onto or enters a vessel, pipeline, or other means of transportation to be transported from the Contract Area;

"**Financial institution**" means any licensed bank or other licensed legal person that is primarily engaged in the business of making credit extensions or investments for the account, and the risk, of the person carrying on the business;

"**Goods**" means any substance, organism, article or thing, whether manufactured or natural, which is not a human body, cadaver or human remains;

"**Head Office Expenditures**" means any executive, management, or general administration expenditures incurred by a non-resident person in the ordinary course of business, and which expenses are incurred solely and primarily for business purpose and for the benefit of the permanent establishment of the person in Timor-Leste;

"**Intangible Asset**" means any property, other than tangible movable or immovable property, that:

a) has a useful life exceeding one year;
b) is used wholly or substantially in the conduct of taxable business activities;

"**Intangible expenditure**" means any expenditure incurred other than in the acquisition of any tangible movable or immovable property, or tangible asset;

"**Interest**" means:

a) any amount (including a premium or original issue discount) paid or accrued under a debt obligation that is not a repayment of capital and pursuant to petroleum operations; or
b) any amount that is functionally equivalent to an amount referred to in paragraph (a), such as amount paid or accrued under an interest rate swap agreement or as defaulted under a guarantee agreement, pursuant to petroleum operations;
c) any commitment, guarantee, service, or similar fee payable in respect of a debt obligation or other instrument or agreement giving rise to interest under paragraphs (a) or (b);

For the purposes of Section 74 of the Taxes and Duties Act, 2008 as amended or modified, the interest referred to in paragraphs (a)-(c) must be charged by a bank.

"**International Financial Reporting Standards**" means the most recent International Financial Reporting Standards issued by the International Accounting Standards Board or any successor entity taking over the role of issuing International Financial Reporting Standards;

"**Law on Income Tax**" means the Taxes and Duties Act, 2008, including any amendments and Regulations thereunder, and such other laws applicable in Timor-Leste under UNTAET Regulation No. 1999/1;

"**Legal Person**" means:

a) any limited liability company, joint stock company, general partnership, limited partnership, or other unincorporated association or body of persons, whether incorporated, formed, organized, or established in Timor-Leste or elsewhere;
b) any trust, undivided estate of a deceased natural person;
c) a government, a political or administrative subdivision of a government in whatever name or form, or public international organisation, or an entity, organisation, association, or business form owned by a government, political subdivision of a government, or public international organisation;

"**Long-Term Contract**" is a contract for manufacture, installation, maintenance, or construction, or services related thereto, that is not completed in the tax year in which work under the contract commenced, other than a contract estimated to be completed within six months of the date on which work under the contract commenced;

"Management Services" means the provision of managerial services, consulting, supervisory or other similar services for a fee between related parties;

"**Member**" in relation to a legal person means a shareholder, partner in a partnership, or any other person with a membership interest in a legal person;

"**Method of Accounting**" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item;

"**Mining**" means any method or process by which any mineral is taken from the soil or from any substance or constituent of the soil;

"**Mining Support services**" means every service relating to mining other than technical, management, consulting, or architectural services;

"**Natural Gas**" means all gaseous hydrocarbons and inerts, including wet mineral gas, dry mineral gas, casing head gas, and residue gas remaining after the extraction of liquid hydrocarbons from wet gas, but not crude oil;

"**Natural Resources**" means any mineral, petroleum, or any other living or non-living resource that may be taken from the land or sea;

"**Non-Resident Person**" means any person who is not present in Timor-Leste for a period of, or periods in aggregate to, one hundred and eighty three days or more in the tax year in aggregate;

"**Non-Wage Benefits**" means any reward for services provided by an *employer* to an *employee*, including:

(a) the market value of any non-cash benefit provided by an *employer* to an *employee*;
(b) the value determined by the *Commissioner* of the provision by the *employer* to an *employee* of the use of a motor vehicle wholly or partly for private purposes of the *employee*;
(c) the value determined by the *Commissioner* of the provision by the *employer* of accommodation or housing;
(d) the value determined by the *Commissioner* of the provision by an *employer* to an *employee* of a housekeeper, driver, guard, gardener, or other domestic assistant; and
(e) the cost to the *employer* of providing an *employee* with any meal, refreshment, or entertainment except in the course of providing a *good* or service for the *employer* where the *Commissioner* considers that the cost of provision for the *employer* is reasonable;

"**Permanent Establishment**" means:

(a) a place of management;
(b) a branch;
(c) a representative office;
(d) an office;
(e) a factory;
(f) a workshop;
(g) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources, including any place of drilling for mineral exploration;
(h) a fishery, place where animal husbandry is conducted, farm, plantation, or forest'
(i) a construction, installation, or assembly project;
(j) the furnishing of services through employees or other personnel, if conducted for more than sixty days in any 12-month period;
(k) a natural legal person acting as a dependent agent; or
(l) an agent or employee of a non-resident insurance company, if the agent or employee collects premium, or insures risks, in Timor-Leste;

"**Person**" means:

(a) a natural person, including a sole trader;
(b) a company, wherever incorporated, or other juridical person;
(c) a partnership, wherever formed;
(d) a trust, wherever established; or
(e) any other unincorporated association or body of persons;

"**Petroleum**" means:

(a) any naturally occurring hydrocarbon, whether in a gaseous, liquid or solid state;
(b) any mixture of naturally occurring hydrocarbons, whether in a gas, liquid or solid state; or
(c) any petroleum (as defined above) that has been returned to the reservoir;

"**Petroleum Agreement**" means

(a) a contract, licence, permit, or other authorization in relation to petroleum operations made or given pursuant to the Timor-Leste Petroleum Act, except Seepage Use Authorisation; or
(b) an authorisation or production sharing contract made under the Code;

"**Petroleum Operations**" means authorized activities under a Petroleum Agreement;

"**Reserves**" means the estimated quantity of petroleum or gas that can be expected to be profitably extracted, processed, and sold under the current and foreseeable economic conditions;

"**Reservoir**" means an accumulation of petroleum in a geological unit limited by rock, water or other substances without pressure communication through liquid or gas to another accumulation of petroleum;

"**Resident**" in respect of a natural person means:
a natural person who is present in Timor-Leste for more than 183 days in a tax year unless the person's permanent place of abode is not in Timor-Leste;

"**Royalty**" means any amount, however described or computed, whether periodical or not, as consideration for:

(a) the use or right to use any copyright, patent, design, or model, secret formula or process, trademark, or other like property;
(b) the use or right to use any motion picture films, films or video tapes for use in connection with television or internet broadcasting, or tapes for use in connection with radio or internet broadcasting;
(c) the receipt of, or right to receive, any visual images or sounds, or both, transmitted by satellite, cable, optic fiber, or similar technology in connection with television, radio, or internet broadcasting;
(d) the supply of any scientific, technical, industrial, or commercial knowledge or information;
(e) the use of or right to use any tangible movable property;
(f) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property, supply, or right as mentioned in paragraphs (a)-(e);
(g) the partial or total forbearance in respect of any matter referred to in paragraphs (a)-(f); or
(h) the disposal of any property or right referred to in paragraphs (a)-(g);

"**Sales Tax Value**" means:

(a) for imported taxable *goods*, the *customs value* of *goods* increased by any import duty and excise tax payable on the importation of the *goods*;
(b) for taxable goods sold in Timor-Leste, the price of the *goods* not including any sales tax; and
(c) for taxable services provided in Timor-Leste, the price of the service not including any sales tax;

"**Seepage Use Authorisation**" has the meaning in the Timor-Leste Petroleum Act;

"**Services**" includes the hiring of equipment;

"**State-Owned Contractor**" means the Contractor incorporated under the laws of Timor-Leste, which is controlled directly or indirectly, by Timor-Leste;

"**Subcontractor**" means any person supplying goods or services directly or indirectly to a Contractor in respect of Petroleum Operations;

"**Tax Administration**" means the National Directorate of Petroleum Revenuer or any other public bodies or central services charged under the laws of Timor-Leste to carry out the enforcement of petroleum tax laws and collect petroleum taxes and duties, Commissioner or the Minister of Finance or another competent member of the Government, when exercising their administrative power in relation to tax matters, including policies and regulations;

"T**axpayer**" is anybody, individual or corporate, who or which, pursuant to the provisions in the tax laws, is required to fulfill tax obligations, including tax withholders of certain taxes be it income or wages related, those required to make tax payments in relation to oil and gas business in certain designated areas but excluding the Annex part of the Joint Production Development Area;

"**Tax Assessment**" means understatement of tax and or underpayment of tax including interest and any additional tax imposed under Sections 72, 73 and 74 of UNTAET Regulation 2000/18;

"**Taxable Business Activities**" means business activities carried on to derive business income and which is includible in gross income;

"**Tax Form**" means:

(a) an annual income tax form, including all the required information and or data;
(b) an annual Supplemental petroleum tax form, including all the required information and or data;
(c) an annual wage income tax withholding information form, including all the required information and or data;
(d) an excise tax form;
(e) the income and Supplemental petroleum tax instalment forms, ;
(f) an income tax withholding form;
(g) a sales tax form;
(h) a services tax form;
(i) a wage income tax withholding form;
(j) any forms designated by the *Commissioner* for the purposes of *persons* applying for tax identification numbers and being registered for tax purposes;
(k) any forms designated by the *Commissioner* under Section 45.1(c); or
(l) any consolidated form designated by the *Commissioner* which includes the information from 2 or more of the above forms;

provided that where, in relation to any *person*, any consolidated form has been designated by the *Commissioner*, then the forms which that consolidated form has replaced shall no longer be "tax forms";

"**Tax Period**" means a calendar month or calendar year, unless otherwise stipulated by the Commissioner and or the Minister of Finance, as the case may be;

"**Tax Return**" means a form designated as such by the Commissioner under Section 42 of UNTAET Regulation 2000/18 or described in Section 3 of the UNTAET Regulation 2000/18, including all the required information and or data or a form used by a Taxpayer to report the calculation and payment of tax due pursuant to the provisions of the applicable tax laws;

"**Tax Treaty**" means:

(a) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a sovereign country providing for the relief from double taxation and the prevention of fiscal evasion; or
(b) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a foreign country providing for reciprocal assistance in the enforcement of income tax liabilities;

"**Tax Year**" means the 12 month period from 1 January to 31 December, or if a taxpayer has permission to use a substituted tax year, the substituted tax year;

"**Timor-Leste**", when referring to a geographic area, means the territory of Timor-Leste and its territorial waters, the economic zone off the coast of Timor-Leste recognized under the law of the sea and, to the extent allowed by treaty;

"**Timor-Leste Petroleum Act**" means the Timor-Leste Petroleum Act, 2004 as amended, varied, modified, or replaced from time to time, and includes any regulations and amendments made under the Act;

"**Timor Sea Treaty**" means the Timor Sea Treaty dated 20 May 2002 between the Government of the Democratic Republic of Timor-Leste and the Government of Australia;

"**Total Approved Decommissioning Costs**" means the total decommissioning costs approved by the responsible Ministry or Designated Authority in writing, as the case may be, in accordance with the Decommissioning Plan provided under the Petroleum Agreement, as revised or amended from time to time;

"**Transaction**" means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer;

"**True taxable income**" means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto);

"**Uncontrolled comparable**" means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology.

"**Uncontrolled taxpayer**" means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests;

"**Underlying Ownership**" in relation to a legal person, means a membership interest in the person held, directly or indirectly through an interposed legal person or persons, by a natural person or by a person not ultimately owned by natural persons;

"**Wages**" means any reward for services provided by an *employer* to an *employee*, including:

(a) any salary provided to the *employee,* including leave pay, overtime payments, commissions, and bonuses;
(b) director's fees;
(c) the value of gifts provided by an *employer* to an *employee*;
(d) any allowance provided by the *employer* for the benefit of an *employee*;
(e) any payment provided by the *employer* in respect of loss or termination of employment;
(f) any payments however described made on termination of employment in respect of entitlements outstanding at the time of termination;
(g) the reimbursement or discharge by an *employer* of any expense of the *employee* including utilities expenses;
(h) the amount of any reimbursement or discharge by an *employer* of an *employee*'s medical expenses;
(i) the amount of any waiver where any *employer* waives an obligation of the *employee* to pay an amount owing to the *employer*; and
(j) *Non-wage benefits* greater than $20 provided in a calendar month to *employees* of an *employer* that is exempt from income tax;

"Verification" is a series of steps undertaken to evaluate the completeness and accuracy of an information provided to the Commissioner and or the tax administration of Timor-Lest.

Section 5.1
Sources of Income

An amount is Timor-Leste-source income to the extent to which the amount is connected with the performance of petroleum operations:

(a) income from petroleum operations carried on by a Contractor or Subcontractor resident in Timor-Leste; or
(b) by a non-resident through a permanent establishment in Timor-Leste as determined under Section 6 of the present Regulation
(c) income from the alienation of any movable property of a Contractor used in deriving Timor-Leste-source income referred to in paragraphs (a) and (b);
(d) income from the lease of immovable property in Timor-Leste whether improved or not, or from any other interest in or over immovable property, including the right to explore for, or exploit, natural resources, in Timor-Leste;
(e) income from the alienation of any property or right referred to in paragraph (d) or from the alienation of any ownership interest in a legal person the assets of which consist wholly or principally of property or rights referred to in paragraph (d);
(f) dividend paid by a resident or permanent establishment;
(g) interest, royalties, management fees, annuity, or any other income paid by a resident or borne by a permanent establishment in Timor-Leste of a non-resident;
(h) income from services rendered in Timor-Leste relating to construction, building activities, construction consulting services, air or sea transportation, mining and mining consulting services, insofar as the remuneration is paid by a resident person or borne by a Timor-Leste permanent establishment of a non-resident person;
(i) notwithstanding paragraphs (a)-(h), an amount taxable in Timor-Leste under an international agreement or Treaty;

5.2.
Income is a foreign–source to the extent to which it is not Timor-Leste-source income.

Section 6
Permanent Establishments

6.1.
The taxable income of a non-resident carrying on business activities in connection with petroleum operations through a permanent establishment as a Contractor or Subcontractor in Timor-Leste shall be determined by reference to the income attributable to:

(a) the permanent establishment;
(b) any sales in Timor-Leste of goods or merchandise or the performance of services in Timor-Leste of the same or similar kind as those effected through the permanent establishment.

6.2.
The taxable income of a non-resident person carrying on business activities in connection with petroleum operations through a permanent establishment as a Contractor or Subcontractor as the case may be in Timor-Leste shall include the income attributable to:

(a) capital gains arising in connection with the alienation of any property within the JPDA and or Timor-Leste exclusive area, including asset, shares or comparable interest, held directly or indirectly in the permanent establishment that is a Contractor or Subcontractor;

(b) the following principles apply in the determination of the taxable income of a Timor-Leste permanent establishment:

i. the profit of the permanent establishment shall be calculated on the basis that the permanent establishment is separate and distinct legal entity engaged in the same or similar services under the same or similar conditions and dealt with wholly independently from the non-resident person of which it is a permanent establishment;

ii. subject to the present Regulations and Section 75 of the Taxes and Duties Act 2008, deductions may be claimed for necessary and ordinary expenses incurred for the purposes of the business activities of the permanent establishment including allowable head office expenditures so incurred, whether in Timor-Leste or elsewhere;

iii. no deduction is allowable to the permanent establishment except where the deductions claimed by the permanent establishment as payment to the head office or another permanent establishment of the non-resident person, other than for the reimbursement of actual expenses incurred by the non-resident person to third parties (not including related party), by way of:

1. royalties, fees, or similar payments for the use of intangible or tangible asset by the permanent establishment;
2. compensation for any services, including management services performed for the permanent establishment;
3. interest on moneys lent to the permanent establishment, except in connection with a transaction involving a bank or banks;

(c) no account is taken in the determination of the gross income of a permanent establishment of amounts charged by the permanent establishment to the head office or to another permanent establishment of the non-resident person, other than towards reimbursement of actual expenses incurred by the permanent establishment to third parties (not including related parties), by way of:

1. royalties, fees, or similar payments for the use of intangible or tangible asset by the permanent establishment;
2. compensation for any services, including management services performed for the permanent establishment;
3. interest on moneys lent to the permanent establishment, except in connection with a transaction involving a bank or banks.

The assessable income of the non-resident person under Section 6 of this Regulation shall be subject to 30% tax in Timor-Leste.

Section 7

Tax Subjects

7.1

For the purposes of Section 70, Chapter IX of the Taxes and Duties Act, including any amendments, the following are Tax Subjects;

(a) a natural person;

(b) an undivided estate as a unit in lieu of the beneficiaries;
(c) a body in the form of a limited company, formed in Timor-Leste;
(d) a partnership, limited or unlimited, formed in Timor-Leste;
(e) any other forms of business, whether private or public, incorporated or formed under Timor-Leste laws;
(f) any legal person established under foreign laws and organized in a manner comparable to entities referred to in paragraphs (c)-(d) above, including trust; or
(g) any other body of persons formed under foreign law.

7.1.1
Exclusions from Tax Subjects: The following persons are excluded from the definition of Tax Subjects:

(a) a representative of a foreign government;
(b) diplomatic and consular representatives or other foreign officials;
(c) international bodies as determined by the Minister of Finance provided they do not conduct business or engage in other for-profit activities in Timor-Leste.

7.2.
(a) the tax obligations of a natural person shall commence at the time the individual is born, present or intends to reside in Timor-Leste and shall cease at the time of death of the individual or leaves Timor-Leste permanently;
(b) the tax obligation of a person other than a natural person, however formed, shall commence at the time the person is established or domiciled in Timor-Leste and shall cease at the time the person is dissolved or is no longer domiciled in Timor-Leste;
(c) the tax obligations of a person or body shall commence at the time the person or body initiates business or engages in business as individual or body, whether as a permanent establishment or not and shall cease at the time the business or activities are terminated.

Notwithstanding the provisions of Section 7, an existing tax liability of a person or body will survive the death, dissolution, cessation and or termination of business activities, as the case may be.

Section 8
Taxable Income

Taxable income is any economic increase arising from the business activities of a taxpayer and which is received or accrued by the taxpayer, in whatever name or form and originating from within or without Timor-Leste, including but not limited to:

(a) gains from alienation of property, including:
  i. gains from the transfer of property to a corporation, partnership and other body in exchange for shares or capital participation;
  ii. gains accrued by a corporation, partnership or other body through the transfer of property to shareholders, partners or members;
  iii. gains from liquidation, merger and or acquisition, consolidation, expansion, separation, transfer or takeover of a business;

iv. gains from the transfer of property in the form of gift, aid or donation, except when given to a related party (by blood or ownership structure);

(b) refunds of tax payments already deducted as expenses;
(c) interest, including premiums, discounts and compensation from loan repayment guarantees;
(d) dividends, in whatever name or form;
(e) royalties;
(f) rent or other income related to the use of property;
(g) gains from cancellation or forgiveness of debt;
(h) gains from foreign currencies;
(i) reimbursements from insurance in respect of losses already deducted as expenses;
(j) lottery prizes or awards;
(k) profits arising from the conduct of any business activities ;
(l) remuneration, wages or other consideration, whether in cash or a property, received or accrued in connection with work or services including salary, allowance, honorarium, commission, bonus, gratuity, and pension.
(m) income from the business or activities of a permanent establishment and from property it owns or control in Timor-Leste;
(n) income of a head office and or a related party arising from the sale of goods or performance of services in Timor-Leste of the same type as those undertaken by the permanent establishment in Timor-Leste; and
(o) any income received or accrued by the head office and or related party, provided the property or activities which produce the income are effectively connected to the permanent establishment.

8(b)
Expenses associated with income as stipulated in subparagraphs (n) and (o) above may be deducted from the income of the permanent establishment.

Section 9
Exempt Income

The following income is exempt from taxable income:

(a) aid or donations, provided the donor are not related parties, whether by blood or ownership structure,;
(b) property (including cash) received by a legal person in exchange for shares or capital contribution, provided the contribution was made as part of the capitalization of the legal person and evidenced as a subscription for shares in the books of the legal person
(c) an amount paid by an insurance company to reimburse the taxpayer for a loss, other than a loss that has been previously deducted.

Section 10

Deductions Allowed against Income Tax

10.1

The amount of a taxable income of a taxpayer shall be determined based on the amount of gross income less the following deductions:

(a) necessary and ordinary expenditures incurred, and losses connected with the alienation of assets used in Petroleum Operations within the Contract Area;
(b) necessary and ordinary expenditures incurred in deriving an amount that is includible as part of gross income, including costs to purchase materials, costs connected with work or services including salaries, wages, honoraria, bonuses, gratuities directly connected with Petroleum Operations in a Contract Area;
(c) interest payment on loans or obligations from a bank and which loans were obtained directly and specifically in connection with Petroleum Operations in a Contract Area and the borrower bears the economic risk of default;
(d) rent, insurance premiums directly connected with Petroleum Operations within a Contract Area;
(e) administrative cost directly connected with Petroleum Operations in a Contract Area;
(f) royalties paid or accrued directly in connection with Petroleum Operations in a Contract Area;
(g) depreciation of tangible assets and amortization of intangible assets and other costs with a useful life of more than one (1) year as provided in Sections 77 and 78 of the Taxes and Duties Act, over which the Contractor has a claim of title in law and located within the working area of the Contractor in Timor-Leste;
(h) loss arising from the sale or transfer of property owned and used in business or owned for the purpose of earning, recovering and securing income in connection with Petroleum Operations in Timor-Leste,; and provided the sale is conducted in open market and not below the fair market value of the property;
(i) loss arising from fluctuations in foreign currencies directly connected with the Petroleum Operations of the Contractor in Timor-Leste;
(j) costs of training, apprenticeship and scholarship awards to citizens of Timor-Leste not exceeding US$50,000 per tax year and subject to the prior approval of the Minister of Finance and such approval must be obtained during the tax year in which the expense was incurred;
(k) charitable contributions to public institutions in Timor-Leste not exceeding US$200,000 per tax year and subject to the prior approval of the Minister of Finance and such approval must be obtained during the tax year in which the expense was incurred;
(l) an amount approved in writing by the Designated Authority as the decommissioning cost reserve for the current tax year under 76.2 of the Taxes and Duties Act;
(m) an amount of Timor-Leste Supplemental Petroleum Tax of a Contractor for the tax year calculated under Section 83 of the Taxes and Duties Act and or Section 32 of the present Regulations.

10.2
The amount that a Contractor may deduct under subparagraph 10.1 of the Regulations and Section 73 of the Taxes and Duties Act in relation to Petroleum Operations is limited to:

(a) the gross income arising from such Petroleum Operations in the Contract Area in that year; and
(b) the loss arising directly connected to the Petroleum Operations undertaken in the Contract Area for a tax year, and where the loss exceeds the taxable income for that tax year, such loss is carried forward to the next following year and deductible only against gross income arising from such Petroleum Operations in the Contract Area until the loss is exhausted within the Contract Area or the expiration of the Petroleum Agreement in respect of the Contract Area, whichever comes first.

10.3
Where a Production Sharing Contract ("original') in respect of the JPDA (other than Annex F) entered into with a Contractor before January 1, 2008 is terminated and a new Production Sharing Contract ("successor") is entered into with the same Contractor, any loss carry forward of the Contractor at the time of the termination of the original Production Sharing Contract in respect of the Contract Area covered by the Production Sharing Contract is deductible in the first year of the Contractor for the Contract Area covered by the successor Production Sharing Contract, provided:

(a) the whole of the geographic area covered by the Contract Area of the successor Production Sharing Contract is within the Contract Area of the original Production Sharing Contract; and
(b) no time lapse between the successor Production Sharing Contract and the original Production Sharing Contract

Time lapse as used in subparagraph 10.3(b) means more than one (1) business day.

Section 11
Non-Deductible Expenses

In determining the taxable income of an income taxpayer, non-deductible items shall be:

(a) distribution of profits such as dividends and by whatever name or form;
(b) penalties of any kind, penal or administrative;
(c) additional taxes imposed under the present Regulations and Sections 72-74 of the UNTAET Regulations 2000/18;
(d) excessive compensation paid by a legal person for work performed and paid to shareholders or related parties as compensation;
(e) incentives, pension fund payments, and insurance premiums for personal interest and/or the families of expatriate employees, management and shareholders;
(f) losses arising from a transaction with a related party where transactions were determined by the Commissioner not to be at arm's-length;
(g) costs incurred for the benefit of a related party or shareholders;

(h) bad debts;
(i) exploration and development costs incurred before the commencement of commercial production and which are required to be capitalized;
(j) reserves, other than approved decommissioning cost reserve under Section 76 of the Taxes and Duties Ac;
(k) gifts, scholarship, apprenticeship, aids or donations other than those in accordance with Section 10 of this Regulation;
(l) salaries paid to members of an association, limited or unlimited partnerships without share capital;
(m) costs incurred by a Contractor and not in connection with a Contract Area as defined under the relevant Production Sharing Contract;
(n) if an income taxpayer is required to withhold tax from a payment that is deductible as necessary and ordinary business expense of the taxpayer, including payment of wages, the deduction is not allowed until the taxpayer pays the withheld tax to the Tax Administration;
(o) a fine or other monetary penalty imposed for violation of any law, rule or regulations;
(p) a bribe or any similar amount;
(q) an expenditure or loss incurred to the extent recoverable under a policy of insurance or contract of indemnity;
(r) the acquisition costs of an asset having a useful life of more than one (1) year;
(s) payments made by a permanent establishment to a head office or related party as royalties or other similar compensation in connection with property, patents or other similar rights;
(t) compensation in connection with management services between related parties;
(u) interest payments made by a permanent establishment to a head office or related party except when connected with a debt or loan from a bank and directly connected with Petroleum Operations in Timor-Leste;
(v) the following payments made by permanent establishment to a head office or related party:

1) long-term corporate planning;
2) policy;
3) public and government relations
4) finance\treasury;
5) advertising, donations, sponsorship;
6) entertaining;
7) legal; and
8) intra-group relations.

Chapter II

Section 11A
Allocation of Head Office Expenditures

Subject to Section 11 of the present Regulations, if a Contractor or Subcontractor is a non-resident person with a Timor-Leste permanent establishment, the amount of Head Office Expenditures deductible under Section 6.2(b)(ii) of the present Regulation and Section 75 of the

Taxes and Duties Act, for a tax year shall be limited to a maximum of two-percent (2%) of the total deductible expenditures, excluding any depreciation and amortization deductions under this present Regulations and or the Taxes and Duties Act, 2008.

Section 12

Limitation on Interest Deduction for Contractors

12.1.

Notwithstanding the provision of Section 10.1(c) of the present Regulation, a Contractor is allowed a deduction for interest expense incurred in relation to petroleum operations where:

(a) the cost of money to the Contractor is substantially the same as charged in the open market by banks for similarly situated persons;
(b) the deductible amount is limited to twenty-five percent (25%) of the Contractor's non-interest income for the tax year.

12.2.

A Contractor's net non-interest for the year is calculated according to the following formula:

(X-Y) - T x 25%

Where:

X is the Contractor's gross income for the tax year;
Y is the interest income for the tax year; and
T is the total deductions for the Contractor other than interest expense for the tax year
25% is the apportionment factor

Section 13

Loss and Interest Expense Carry Forward

13.1

Except for interest expense for a Contractor, if the determination of the taxable income of a taxpayer results in a loss for a tax year, that loss may be deducted as an expense in calculating the taxable income of the taxpayer in subsequent tax years until the loss is utilized in full or the Petroleum Operations in the Contract Area cease.

13.2

If a Contractor has an excess interest deduction under Section 74.2 of the Taxes and Duties Act, 2008 the excess interest deduction may be carried forward for a maximum of five (5) years from the tax year that the excess arose. Where a Contractor has an amount of interest expense carried forward for more than one tax year and which arose in different tax years, the interest expense incurred in the earliest year is deducted first

Section 14

Basis and Method of Accounting

14.1

The determination of the gross income and deductions of a taxpayer from the conduct of business activities connected directly or indirectly with petroleum operations shall be based on the taxpayer's net profit for financial accounting purposes for the year. The profit and loss and the balance sheet must be prepared in accordance with the most updated version of the International Accounting Standards or the Generally Accepted Accounting Practices applicable to the taxpayer, and subject to the modifications contained in the present Regulation and the Taxes and Duties Act, 2008.

The profit and loss statement and balance sheet must be exhibited with the annual income tax return of the taxpayer.

14.2

Every taxpayer shall account for income tax on accrual basis. A taxpayer using the accrual method of accounting recognizes income when it is earned or receivable and incurs an expense when its payable. Except for deviations permitted or required by such special accounting treatment under the tax applicable laws and regulations, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

14.3

Subject to this Regulation, an amount is receivable by a taxpayer when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy, but not before economic performance. Economic performance occurs when:

(a) in the case of acquisition of services or assets, at the time the services or assets are provides;
(b) in case of use of assets, at the time the assets are used; and
(c) in any other case, at the time the taxpayer makes payment in full satisfaction of the liability.

Section 15

Inventory

15.1

Inventories shall:

(a) conform as nearly as may be to the best accounting practice in the trade or business, and
(b) must clearly reflect the income.

15.2.

Inventories shall be valued at cost or market, whichever is lower. Where inventories are valued at cost by the Contractor, the cost shall be determined according to the absorption-cost method.

15.2.2
Where particular items of inventory are not readily identifiable, a Contractor may account for inventory under first-in-first-out (FIFO) or the weighted average cost method.

15.2.3
A change of inventory method is permissible subject to the written approval of the Commissioner and subject to any terms and conditions that the Commissioner may impose to reflect accurate income and expenditures.

15.3

(a) Use of full absorption method of inventory costing. In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income as required by section 15.1(b) of the present Regulations, both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory;
(b) the taxpayer must include as inventoriable costs all direct and indirect production costs ;
(c) costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs;
(d) costs classified as "direct production costs" are generally those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of production or manufacturing and can be identified or associated with particular units or groups of units of that product;
(e) direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units;
(f) the term "indirect production costs" includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (d) of this paragraph). Indirect production costs may be classified as to kind or type in accordance with acceptable accounting principles so as to enable convenient identification with various production or manufacturing activities or functions and to facilitate reasonable groupings of such costs for purposes of determining unit product costs.

Section 16

Depreciation

16.1

The depreciation deductions allowable under Section 10(g) of the present Regulations are permissible only when the Contractor is the legal and titled owner of the asset, and the asset is used in furtherance of the business activities of the taxpayer. The legal right to depreciate the asset must not reside in a different taxpayer, even where related to the taxpayer.

16.1(a)

The acquisition and or construction costs, improvements or repairs that enhance the value or convert the asset from one use to the other or prolong the life of a business building are required to be depreciated on a straight-line basis at the rate specified in Schedule X, Section A, Business Buildings.

16.1(b)

The cost of acquiring the land upon which the business building is constructed or erected is excluded from the tax basis of the taxpayer in the business building and such must be excluded in the computation of the depreciation deductions under Section 77.1of the Taxes and Duties Act, 2008.

16.1(c)

A depreciable asset may be depreciated:

(a) individually on a straight line basis or
(b) by pooling of assets with similar life on a declining balance basis.

16.1(d)

Immediately after the date of the commencement of the present Regulations, Contractors are required to elect their depreciation method and inform the Commissioner in writing accordingly.

16.1(e)

The depreciation method elected by a taxpayer must be applied uniformly to all depreciable assets of the taxpayer.

16.1(f)

A taxpayer may change a method of depreciation previously elected upon a written application made to the Timor-Leste Tax Administration stating the basis of the application and affirm under oath that the change sought will not distort the income and expenses of the taxpayer.
The Tax Administration may approve the application subject to terms and conditions.

16.1(g)

If a taxpayer elects the classification of business building assets into pools of similar assets, the depreciation deduction for each depreciation pool for a tax year is calculated by applying the rates specified in Schedule X, Section B, parts 1and 2 of the Taxes and Duties Act 2008, to the written down value of the assets.

16.1(h)
If a taxpayer elects the individual straight-line depreciation method in respect of business building assets, the depreciation deduction for a tax year is calculated by applying the rates specified in Schedule X, Section B, part 3 of the Taxes and Duties Act 2008.

16.1(i)
If there is a change in the Reserve estimated by a Contractor under a Development Plan for Petroleum Operations and which is approved by the Designated Authority, the Contractor may apply to the Tax Administration for a change or variation of a method of depreciation previously elected. The application to the Tax Administration shall be in writing and the basis must be clearly indicated.

16.1(j)
The Tax Administration may upon notice to taxpayers change the classification and the rates of depreciation for depreciable assets.

16.1(k)
Notwithstanding the provisions of paragraphs 16.1(g) and (h), any Contractor who has been advised by the Commissioner in writing prior to the commencement of the present Regulations to use a different depreciation methodology other than as prescribed herein, may continue to use the methodology previously approved by the Commissioner.

Section 17
Amortisation

17.1
Exploration expenses, including those incurred by a Contractor prior to commercial production, is characterized as intangible expenditure with a useful life equal to the expected life of the Petroleum Operations under a Petroleum Agreement or five (5) years, whichever is the lesser, and accordingly.

17.1(a)
Development Expenditures incurred under a Petroleum Agreement is classified as intangible expenditure with a useful life equal to the expected life of the Petroleum Operations under the Agreement or ten (10) years, whichever is lesser.

17.1(b)
Exploration and Development Expenditures are required to be amortised on a straight-line basis only and the depreciation deductions for each tax year is calculated by applying the rates specified in Schedule X, Section C of the Taxes and Duties Act 2008. A contractor

17.1(c)
Any depreciable or intangible asset acquired, created, constructed or incurred before the commencement of commercial production is required to be capitalized and the depreciation or amortization deductions of such asset commences from the time commercial product commences.

17.1(d)
Commercial production is deemed to commence from the first day of the first period of thirty (30) consecutive days during which the average level of regular production delivered for sale on the twenty five (25) highest production days in a thirty-day period reaches a level of regular production delivered for sale as may be determined by the Minister of Finance or the Commissioner, upon the advice of the Designated Authority.

17.1(e)
In the tax year in which Commercial production commences, the depreciation or amortisation deduction for that year is calculated ratably by applying the formula specified in Section 77.6 of the Taxes and Duties Act, 2008.

17.1(f)
If there is a change in the Reserve estimated by a Contractor under a Development Plan for Petroleum Operations and which is approved by the Designated Authority, the Contractor may apply to the Tax Administration for a change or variation of a current amortization methodology. The application to the Tax Administration shall be in writing and the basis must be clearly indicated.

Section 18
Small Field: Depreciation and Amortisation

18.1
If a field is determined by the Designated Authority to produce eighty percent (80) or more of the estimated Reserves within five (5) years from the date of the commencement of commercial production as determined under Section 77.5 of the Taxes and Duties Act 2008, then the Contractor may:

(a) apply to the Commissioner, and upon approval of such application, elect the "units of production" methodology as the basis of depreciation and amortisation for all depreciable assets, including Exploration and Development expenditures. Such election must be made as part of the Development Plan and filed with the Tax Administration upon the approval of the Development Plan;
(b) the depreciation or amortisation deduction for a tax year when calculated by using the "units of production" method, is determined by applying the formula specified in Section 78.3 of the Taxes and Duties Act, 2008;
(c) the election under subparagraph (a) above, when granted, is applicable to all the depreciable assets used in the Petroleum Operations referred to in Sections 78.1-2 of the Taxes and Duties Act, 2008; and
(d) where a Contractor has more than one Development Plan for a Contract Area, Section 17 of this Regulation applies separately to each Development Plan.

Section 19
Decommissioning Costs Reserve and Decommissioning Expenditure

19.1
The amount of decommissioning expenditure allowable as deduction for a tax year under Section

76 of the Taxes and Duties Act, 2008, is the amount determined for that year under a Petroleum Agreement and arising from the Total Approved Decommissioning Costs agreed upon between the Designated Authority and the Contractor or Contractors.

19.2
As a condition precedent to the tax deductibility of decommissioning cost allowable pursuant to Section 76.1 of the Taxes and Duties Act 2008 in the current year, a Contractor is required to exhibit a copy of the approval granted by the Designated Authority to the annual tax return submitted to the Commissioner and in which a claim is made for such deduction against taxable income and or Supplemental Petroleum Tax.

19.3
The amount of decommissioning costs deductible in a tax year shall be calculated on the basis of the formula prescribed pursuant to Section 76.3 of the Taxes and Duties Act, 2008.

19.4
If, at any time, the total amount deductible under this Section exceeds the Total Approved Decommissioning Costs, the amount of the excess shall be includible in the gross income of the Contractor for the tax year in which the excess occurs.

19.5
The application of Section 18 of the present Regulations and Section 76 of the Taxes and Duties Act other than to the Contractor's current tax year is hereby prohibited.

Section 20
Transfer of a Petroleum Agreement

20.1
A Petroleum Agreement is deemed to be transferred by a Contractor where;

(a) 50% or more of the voting rights or value of the Contractor is transferred or sold directly or indirectly, to another person, including an entity controlled by the Contractor or controlling the Contractor,
(b) all or substantially all of the assets of the Contractor is sold or transferred to another person;
(c) statutory or de facto merger, acquisition, reorganization, amalgamation, liquidation, change of name followed by or preceded by transfer of more than 50% of the voting shares or value of the Contractor to another person; and
(d) a mere change in identity, form, or place of organization of one corporation, however effected, if it is accompanied by either the exchange of shares for cash or other value or the transfer of asset connected with Petroleum Operations from one Contractor to the other.

20.2
Insofar as there is continuity of the business purpose of the transferor Contractor, the transferee Contractor shall:

(a) succeed to the balance of deferred tax asset of the transferor contractor and continue to amortise any Exploration or Development Expenditure in the manner and on the same basis as the original transferor Contractor; and

(b) Sections 15-17 of the present Regulations and Sections 77-78 of the Taxes and Duties Act, 2008 shall apply to any other depreciable assets or intangibles at the rates specified therein.

20.3

For the purposes of paragraph 19.2 above, there is continuity of business purpose where the transferee Contractor is engaged immediately after the transfer of a Petroleum Agreement in an actively conducted trade or business which has been so conducted under the transferred Petroleum Agreement throughout the five-year period ending on the date of the transfer by the transferor Contractor in Timor-Leste.

Chapter III

Section 21

Allocation and Reallocation of Income and Expenditures among Related Parties and or Associates/Anti-avoidance Rules & Policies

The primary purpose of Section 21 of the present Regulation is to amplify the provisions of Sections 91-93 of the UNTAET Regulation 2000/18 to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. The referenced Sections above are intended to put a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This Section sets forth general principles and guidelines to be followed in the determination of the true taxable income and expenditures in transactions involving associates or related parties.

21.1

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the Timor-Leste, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner may distribute, apportion, reapportion, or allocate or reallocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes and or to clearly reflect the true taxable income of any of such organizations, trades, or businesses.

The Commissioner may make such a determination where terms and or conditions are made or imposed between the associated enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises.

21.2

In the case of any transfer or license of intangible property between a Contractor and a party owned or controlled directly or indirectly by the same interest, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible property.

21.3
The Commissioner may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the Commissioner may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

21.3
Generally, in the process of the determination of the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same or identical circumstances (arm's length result).

21.4
The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

21.5
An arm's length result may be determined under any method without requesting a taxpayer to establish the inapplicability of another method, but if another method is subsequently shown to produce a more reliable measure of an arm's length result; such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

21.6
Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule. Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis performed under another method.

Best method rule: The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result; such other

method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

21.7
In general, whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under similar circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors).

21.8
Comparability factors include:

(a) **Functions**
Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include— (A) Research and development; (B) Product design and engineering; (C) Manufacturing, production and process engineering; Product fabrication, extraction, and assembly; (E) Purchasing and materials management; (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities; (G) Transportation and warehousing; and (H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(b) **Material contractual terms and conditions**
Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include— (1) The form of consideration charged or paid; (2) Sales or purchase volume; (3) The scope and terms of warranties provided; (4) Rights to updates, revisions or modifications; (5) The duration of relevant license, contract or other agreements, and termination or renegotiation rights; (6) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and (7) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required.

1. Written agreement. The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. If the contractual terms are inconsistent with the economic substance of the underlying transaction, the Commissioner may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

2. No written agreement. In the absence of a written agreement, the Commissioner may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights. For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the Commissioner may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods.

(c) **Risks**

1. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include— (1) Market risks, including fluctuations in cost, demand, pricing, and inventory levels; (2) Risks associated with the success or failure of research and development activities; (3) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates; (4) Credit and collection risks; (5) Product liability risks; and (6) General business risks related to the ownership of property, plant, and equipment.

2. Identification of taxpayer that bears risk. In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the material provisions of the contractual terms as indicated in Section 20.8(b) above. Consequently, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable may indicate the lack of economic substance. In considering the economic substance of the transaction, the following facts are relevant;

(a) whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the

pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

(b) whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(c) the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(d) **Economic condition**

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include— (a) the similarity of geographic markets; (b) the relative size of each market, and the extent of the overall economic development in each market; (c) the level of the market (e.g., wholesale, retail, etc.); (d) the relevant market shares for the products, properties, or services transferred or provided; (e) the location-specific costs of the factors of production and distribution; (f) the extent of competition in each market with regard to the property or services under review; (g) the economic condition of the particular industry, including whether the market is in contraction or expansion; and (h) the alternatives realistically available to the buyer and seller..

(e) **Nature of property or services involved in the transaction**

Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangible property that is embedded in tangible property or services being transferred. The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied.

21.9

Standard of comparability.

In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

21.10

A material difference is one that would materially affect the measure of an arm's length result under the method being applied. Where practicable, adjustments must be made by the taxpayer to cure the effect of such material differences on prices or profits if such effects can be ascertained with reasonable accuracy to improve the reliability of the results.

If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced.

21.11
Arm's length range:

(a) Generally, the application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(b) Determination of arm's length range

1. **Single method**. The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. Use of more than one method may be appropriate for the purposes of determining the best method.

2. **Selection of comparables**. Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

3. **Comparables included in arm's length range**. Generally, the arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

4. **Adjustment of range to increase reliability**. If there are no uncontrolled comparables described in this Section, the arm's length range selected from the results of all the uncontrolled comparables, should achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables. The reliability of the analysis is increased when statistical methods

are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

5. **Interquartile range**. For purposes of this section, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

6. **Adjustment if taxpayer's results are outside arm's length range**. If the results of a controlled transaction fall outside the arm's length range, the Commissioner may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results, which is determined in a manner analogous to that described in paragraph 20.11(b)(5) of this Section (Interquartile range). In other cases, an adjustment normally will be made to the arithmetic mean of all the results.

7. **Arm's length range not prerequisite to allocation**. The rules of this Section and Sections 91-93 of the UNTAET Regulations 2008/18 do not require that the Commissioner establish an arm's length range prior to making an allocation and or reallocation between related parties.. Thus, for example, the Commissioner may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices, then then no allocation will be made.

8. **Scope of review:**
   The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer.
   i. Intent to evade or avoid tax not a prerequisite: In making allocations under Section or the relevant parts of UNTAET Regulation 2000/18, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a

device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

ii. Realization of income not a prerequisite: The Commissioner may make an allocation under Sections 91 and or 93 of the UNTAET Regulation 2000/18 even if the income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the Commissioner may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year. Similarly, if a controlled taxpayer lends money to a related taxpayer in a taxable year, the Commissioner may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under this Section or under the UNTAET Regulations 2008/18 is not precluded.

iii. Non-recognition provisions may not bar allocation: If necessary to prevent the avoidance of taxes or to clearly reflect income, the Commissioner may make an allocation under this Section and or under the UNTAET Regulations with respect to transactions that otherwise qualify for non-recognition of gain or loss under applicable provisions of Timor-Leste tax laws.

21.12

Rules relating to determination of true taxable income.

The following rules must be taken into account in determining the true taxable income of a controlled taxpayer:

1) **Aggregation of transactions**: The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services.

2) **Allocation based on taxpayer's actual transactions**: The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the

terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the Commissioner may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer.

3) **Multiple year data**: The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be appropriate, however, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years may be used.

4) **Allocations apply to results, not methods**: In evaluating whether the result of a controlled transaction is arm's length, it is not necessary for the Commissioner to determine whether the method or procedure that a controlled taxpayer employs to set the terms for its controlled transactions corresponds to the method or procedure that might have been used by a taxpayer dealing at arm's length with an uncontrolled taxpayer. Rather, the Commissioner will evaluate the result achieved rather than the method the taxpayer used to determine its prices.

5) **Collateral adjustments with respect to allocations under this Section and or Sections 91-93 of the UNTAET Regulations**. In general, the Commissioner will take into account appropriate collateral adjustments with respect to allocations made with respect to related party transactions.. Appropriate collateral adjustments may include correlative allocations, tax credit, conforming adjustments, and setoffs.

Section 22

Transfer Pricing Methods in Connection with the Transfer of Tangible and Intangible Properties

22.1(a)

In general. The arm's length amount charged in a controlled transfer of property must be determined under one of the six methods listed in this paragraph. Each of the methods must be applied in accordance with all of the provisions of Section 21 of the present Regulations, including the best method rule, the comparability analysis of and the arm's length range as described in Section 21 above.

22.1(b)

The transfer pricing methods in connection with the transfer of tangible property are:

(a) the comparable uncontrolled price method;
(b) the resale price method;
(c) the cost plus method;
(d) comparable profit method;
(e) profit split method; and
(f) Unspecified methods.

22.1(c)

Comparable Uncontrolled Price Method ("CUP")

The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction. Provided that the comparability requirement is satisfied, the results derived from applying the CUP method generally be will be the most direct and reliable measure of an arm's length price.

The CUP may be ascertained based on comparable purchases and sales either between the taxpayer and unrelated parties or sales between two unrelated parties. While no two sales are the same, the Tax Administration is of the view that sufficient comparability exists if similar products are sold under the circumstances that are substantially the same, and any differences in the products or circumstances either have no effect on prices or have differences that can be measured and eliminated with a reasonable number of adjustments as indicated in Section 2o above.

A proposed CUP methodology may be adjusted for many factors, including:

(a) quality of the product;
(b) contractual terms like warranty, credit terms, sales volume, or delivery terms;
(c) level of the market-wholesale or resale;
(d) geographic market;
(e) date of the transaction
(f) intangible property associated with the sale;
(g) foreign currency risks; and
(h) purchaser or buyer alternatives.

The CUP method is also allowed where data from public exchanges or quotation media is available for the property. This type of data is useful typically to price intercompany transactions involving commodities products like oil, gas, minerals etc. The following requirements must be met in order to use such data, namely:

1. the data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;
2. the data is used to set prices in the controlled transaction in the same way that it is used by uncontrolled taxpayers in the industry; and
3. the amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by the uncontrolled taxpayers.

Taxpayers should note however, that if there are material products differences for which reliable adjustments cannot be made, the CUP method will not satisfy the best method rule as described in Section 20 above.

22.1(d)

Resale Price Method (RPM)

The resale price method (RPM) is an arm's length evaluation of price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (resale price) is then reduced by an approximate gross margin on this price ("resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and in the light of the functions performed (taking into consideration assets used and quantum of risk assumed), make an appropriate profit. Essentially, the price is determined under the RPM by subtracting the "appropriate gross profit" from the "applicable resale price" of the item involved.

What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm's length price for the original transfer of property between associated enterprises.

The RPM establishes an arm's length price for the sale between a supplier and a related reseller by applying the gross margin achieved in a comparable transaction, but not necessarily involving exactly similar products, to the resale price of the affiliated reseller. Also, the RPM earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide.

Based on the principles established in Section 20 above, an uncontrolled transaction is comparable to a controlled transaction for purposes of the RPM if one or two conditions are met, namely:

1) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or
2) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Other specific factors that may be appropriate for consideration when a taxpayer elects to use the RPM are:

1) contractual terms;
2) functions performed
3) inventory and turnover rates;
4) corresponding risks;
5) sales, marketing, advertising programs; and
6) market level-wholesale or retail.

In cases where the RPM used is that of an unrelated independent enterprise in a comparable transaction, the reliability of the RPM may be affected if there are material differences in the ways the associated enterprises and the unrelated enterprises execute their businesses. Such differences may impact the costs taken into consideration, and consequently affect the profitability level of an enterprise but may not necessarily affect the price at which it buys and sells its goods or services in the market place.

Peculiar circumstances like those mentioned in this paragraph should be analyzed in determining whether an uncontrolled transaction is comparable for purposes of applying the RPM.

22.1(e)

Cost-Plus Method

Generally, the cost-plus method determines an arm's length charge by examining the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services rendered to an associated purchaser. An appropriate markup is then added to this cost. The cost plus the added markup may be regarded as an arm' length price of the original controlled transaction. The cost plus markup of the supplier in the controlled transaction should ideally be established by reference to the cost plus markup that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus markup that would have been earned in comparable transactions by an independent enterprise may serve as a guide

The cost plus method is used mainly in manufacturing, assembly, or other production of goods that are sold to associated enterprises. In determining the arm's length benchmark, adjustments should be made for material differences between uncontrolled and controlled transactions where it can be determined that such differences have definite and reasonably ascertainable effect on the margins. The extent and reliability of such adjustments will affect the relative reliability of the analysis under the cost plus method in certain cases.

Taxpayers using the cost plus method to establish arm's length price should pay particular attention in applying a comparable markup to a comparable cost basis. The cost plus method relies mostly upon a comparison of the markup on costs achieved in a controlled transaction and the markup on costs achieved in or more comparable uncontrolled transactions. In the circumstances, differences between the controlled and uncontrolled transactions that have effect on the size of the markup must be analyzed to determine what adjustments should be made to the uncontrolled transactions respective markup.

Taxpayers using the cost plus method must consider the following factors:

1. complexity of manufacturing or assembly;
2. procurement, purchasing, and inventory-control activities;
3. testing functions;
4. operating and non-operating expenses; and
5. contractual terms.

22.1(f)

Comparable Profit Method (CPM)

The determination of the arm's length price under the comparable profit method is predicated upon objective measures of profitability level indicators ("PLIs") that are derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The method is acceptable so long as it is consistent with the Best Method and comparability rules discussed above.

Under the CPM, the arm's length is determined by calculating what a taxpayer's operating profit would have been on related party transaction if its profitability levels were equal to that of an uncontrolled comparable and then comparing that result with to the interquartile range calculated

based on the results of the comparable enterprises. In calculating the taxpayer's operating profits, the selected PLIs should be applied solely to the taxpayer's financial data that is related to the controlled transactions.

Since the CPM is a profit based method, taxpayers are required to select which of the related parties that engaged in the controlled transactions will be the party whose profits will be tested for meeting the requirements of the arm's length standard. The tested party should be the related party whose operating profit margin attributable to the controlled transactions can be verified using the most accurate data and requiring the least adjustments, and for which reliable comparable data can be located.

In selecting a pool of comparables from which the PLI will be determined, the standards of comparability will allow for diversity of products and functions. Relevant comparability factors may include the size and scope of operations, lines of business, product and markets and balance sheet items. As a result of the peculiarity of this CPM, taxpayers should broaden the functional analysis to cover more dimensions of those business factors that affect profitability.
Taxpayer's choice of a particular PLI out of other PLIs should be based on the nature of activities under review, and on supporting data availability.
Once a particular PLI has been selected by the taxpayer, the arm's length range should be determined by calculating the interquartile range from the company operating profits. The interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables.

22.1(g)
Comparable Profit Split Method
The profit split method compares the allocation of the combined operating profit or loss attributable to controlled transactions to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The profit or loss is then split amongst the associated enterprises on an economically valid basis that approximates the division of profits or loss that would have been anticipated and reflected in an agreement made at arm's length.
The comparative profit method generally divides the total operating income of the buyer and seller in the controlled transaction in a manner that is consistent with the way comparable unrelated parties divide their operating income in similar transactions.

The data on comparable transactions and the resulting profits splits between unrelated parties must be employed, if available. The data must address two independent parties, each having risks, functions, and intangibles substantially comparable to those of the uncontrolled parties. Locating comparable enterprises engaged in transactions that are similar to those of those the buyer and the seller and data distinguishing how the independent parties shared the combined profits from a comparable transaction is extremely difficult.

22.1(h)
Residual Profit Split Method
The residual profit method operates in a two-step process. The first step assigns an arm's length return to the conventional activities of the buyer and the seller in controlled transactions. This allocation is done by first granting the buyer and the seller an arm's length returns for functions

performed that are contributory to the profits. These functions include, manufacturing, advertising and marketing, distribution and the exploitation of intangibles (if any).
The second step involves the allocation of the residual profit between the buyer and the seller based on the corresponding value of their contributions of intangible property to the business activity. Taxpayers are allowed to allocate the residual profits between the buyer and the seller insofar as a discernible benchmark can be established as a basis of the allocation formula. Factors that a taxpayer may include in setting the allocation benchmark may include the capitalized cost of developing the intangibles, enhancements etc.

22.1(i)
Unspecified (other) Methods
Other the arm's length standards mentioned specifically in Section 21 of the present Regulations, taxpayers may use other methods to determine the transfer price prices charged for the exchange of goods or services between related enterprises. As with the other specified methods, taxpayers will be required to demonstrate that the unspecified method selected is consistent with the Best and comparability rules as described in Section 20 above.

Section 23
Transfer Pricing Enforcement and Penalties

23(a)
Civil penalties
The provisions of Sections 73 and 74 of the UNTAET Regulations 2000/18 (including amendments) shall apply *in pari materia* for:

1. transfer pricing *underpayment* of tax arising from any transfer pricing adjustment made by the Tax Administration under the present Regulations or any other applicable laws; and
2. transfer pricing *underpayment* of tax arising from any transfer pricing adjustment made by the Tax Administration under the present Regulations or any other applicable laws.

23(b)
The provisions of Sections 22(a) and 22(b) above are applicable concurrently and independent of each other.

23(c)
Burden of proof
In any related party transaction, the taxpayer shall be responsible for establishing that the transaction is consistent with the arm's length standards as provided in Section 21 of the present Regulations and Sections 91 and 93 of the UNTAET Regulation 2000/18

Section 24
Documentation Requirements

24(a)
A taxpayer with an aggregate related party transaction or transactions in the sum of Five Hundred Thousand US Dollars (US$500,000) or more in a tax year is required to report and disclose such transaction(s) in the income tax return filed for the year in which the transaction(s) occurred. Taxpayers are also required to keep and maintain accessible books and records

containing all relevant information about such transaction(s) for a period of seven (7) years, commencing from the date the information or tax return containing the disclosures is filed with the Tax Administration.
In addition, such taxpayers are required to compile transfer pricing documentation supporting the pricing of the related party transaction(s) in the sum of US$500,000 or more.

24(b)
The transfer pricing documentation requirement of subparagraph 24(a) is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the Best Method Rule as described in Section 21 of the present Regulations and provides that documentation to the Tax Administration within sixty (60) days of a request for it in connection with an examination of the taxable year to which the documentation relates.
The documentation must be in existence when the return is filed. The Commissioner may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known.

24(c)
The principal documents to be maintained by a taxpayer with related party transaction(s) falling within the threshold stipulated in subparagraph 24(a) above includes:

i. an overview of taxpayer's business, including an analysis of the economic and legal factors affecting pricing;
ii. a description of taxpayer's organizational structure covering all related parties engaged in transactions potentially relevant under Section 21 of the present Regulations and Sections 91-93 of the UNTAET Regulation 2000/18;
iii. a description of the method selected and an explanation why the method was selected;
iv. a narrative of the alternative methods that were considered and the reasons for rejecting those alternatives methods;
v. a description of controlled transactions and any internal data used to analyze those transactions;
vi. a description of the comparables that were used, how comparability was evaluated, and what adjustments (if any) were made; and
vii. an explanation of the economic/functional analysis and projections relied upon in developing the method.

Chapter IV

Section 25
Value of Petroleum

25.1
Petroleum shall be valued free on board (f.o.b.) at the point at which petroleum from a Contract Area leaves the Contract Area, or at such earlier point at which it is loaded onto or enters a vessel, pipeline, or other means of transportation to be transported from the Contract Area.

25.2
The value of Crude Oil sold and or exchanged is:

(a) free on board (f.o.b.) or equivalent circumstances at the Field Export Point in transaction between parties that are at arm's length is the price agreed between the parties and payable by the buyer; or
(b) other than f.o.b. or equivalent circumstances at the Field Export Point in transaction between parties that are at arm's length is the price payable by the buyer, less such fair and reasonable proportion of such price that relates to the transportation and delivery of the petroleum downstream of the Field Export Point; and
(c) other than as described in subparagraphs 25(a) and (b), is the price that would have been payable having regard to all relevant circumstances and similar arm's length transactions.

25.2(a)
The Contractor shall bear the burden of establishing that the pricing in subparagraphs 25(a) to (c) is at arm's length and consistent with Section 21 of the present Regulations.

25.3
The value of Natural Gas is the price payable

(a) under the contract approved by the Designated Authority; or
(b) as may be otherwise be provided in the Development Plan; or
(c) as may be otherwise provided in a Petroleum Contract.

25.4
The price payable for petroleum or Natural Gas under this section shall be the respective fair market value, or the price that would be payable by the buyer if the petroleum or the Natural Gas were delivered by the Contractor and taken by the buyer, without conditions such as set off, counterclaim, novation, claim of right or other withholding of any description, nature or form.

Section 26
Withholding Tax

26.1
Any payment made by a Contractor or Subcontractor in respect of any Timor-Leste source services income to a person, other than a payment made to an employee in circumstances where there is an employer-employees relationship, in respect of services acquired for Petroleum Operations, shall be subject to withholding tax at 6% of the gross amount paid.

26.2
Whether or not a particular service is acquired for Petroleum Operations is determined not by the nature of the business of the provider but that of the Contractor or the Subcontractor, insofar as the payment is made for services connected with Petroleum Operations.

26.3
Payments made for tangential services and which are not connected with the core business of a Contractor or Subcontractor engaged in Petroleum Operations is not subject to the withholding tax regime of section 81.

26.4
The core business of a Contractor or Subcontractor is interpreted by the Tax Administration of Timor Leste to mean only the services acquired in furtherance of any permissible business under the Petroleum Agreement applicable to the Contractor and or the Subcontractor making the payment.

26.5
The list of services covered by this Section and Section 81 of the Taxes and Duties Act, includes but not limited to:

a) Accounting/bookkeeping, Tax and legal services;
b) Logging services;
c) Pest extermination and cleaning;
d) Drilling services and supporting of mining oil and natural gas, except what is carried out by permanent establishments;
e) Supporting services in the field of oil and gas;
f) Sound dubbing services and/or film mixing;
g) Catering services;
h) Cleaning services;
i) Brokerage services;
j) Appraisal services;
k) Actuarial services;
l) Supplies;
m) Medical services;
n) Repairs and or Maintenance;
o) Engineering;
p) Consultancy;
q) Lease and Rental services;
r) Labour/Personnel supply;
s) Security;
t) Construction services (except turnkey);
u) Transportation (air, land or sea); and
v) Courier services.

26.6
Supporting services in the field of oil and gas shall include but not limited to:

a. primary cementing service, which is the placement of liquid cement between the cover pipes and opening of the well;
b. remedial cementing services, which is the placement of liquid cement for the following purposes;
c. the re-plugging of empty formation and zone producing water;
d. rectification of a failed or damaged primary cementing;
e. the sealing\closing off of a well;
f. sand control services, which are services which guarantee that parts of the formation which are not consolidated shall not be included in the production of the series of production pipes and eliminate the possibility of getting the pipe blocked;

g. matrix aciding services, which are activities to increase the productivity by way of eliminating the unwanted blockage material;
h. hydraulic fracturing services, which is the work performed in the event the matrix acidizing is not successful, e.g. the maintenance at the formation which has a very mall perforating power;
i. nitrogen and coil tubing services, which are services rendered to eliminate the artificial liquid which is in the completed well, thereby causing the flow which occurred pursuant to the original pressure of the formation and thereafter becomes enlarged as a result of the nitrogen gas which has been pumped into the artificial liquid in the well;
j. drill stem testing services, temporary completion of a new well, in order to evaluate the production capacity;
k. pump services;
l. installation and maintenance services;
m. replacement services of equipment/material;
n. mud logging services;
o. stimulation and secondary recovery services;
p. well logging services and perforating services;
q. stimulation and secondary recovery services;
r. well testing and wire line services;
s. services in regard to off-shore navigational equipment which is related to drilling;
t. maintenance services for the drilling activities;
u. mobilization services and demobilization of drilling extension; and
v. other similar services in the field of drilling oil and gas.

26.7
With respect to lump sum payments made by a Contractor or Subcontractor for services combined with the sale of goods and or reimbursable expenses, the Tax Administration may upon reasonable ground, apportion any part of such payments as subject to the withholding tax under this Section and Section 81 of the Taxes and Duties Act.

Section 27
Finality of Withholding Tax

27(a)
The finality of the taxes withheld pursuant to Section 26 above as full and complete discharge of the liability of the recipient is limited to the value or payments received as consideration for services, and which was correctly subject to Section 81 withholding tax regime.

27(b)
If the beneficiary earned any separate income (e.g. from the sale of goods or interest income, whether combined with services or not) other than arising in connection with the performance of services and which has been correctly subject to the withholding tax regime under Section 26 above, such a person will be required to file an income tax return in Timor-Leste and make the consequential tax payment (if any) accordingly.
The beneficiary will be entitled to exclude the portion of the income already subject to withholding tax from other income reported in the tax return.

27(c)
No deductions for expenditures or loss by whatever name called are allowed against the income subject to withholding tax under the present Regulations and the Taxes and Duties Act. The amount subject to withholding tax is the gross amount paid by the Contractor or the Subcontractor..

Section 28
Withholding Tax on Wages Income

The wage income tax imposed under Section 72.2 of the Taxes and Duties Act and at the rates set out in Schedule IX, is imposed on employees performing services in Timor-Leste, for a Contractor or Subcontractor in respect of an employment in connection with Petroleum Operations in the Timor-Leste Exclusive Area and in the JPDA (excepting Annex F). The tax and at the rates specified in Schedule IX of the Taxes and Duties Act shall be withheld at source by the employer.

Section 28A
Other Income subject to Withholding Tax

Generally, the following income, in whatever name or form, paid by or due from a Contractor or Subcontractor to a non-resident person, shall be subject to withholding tax of 15 percent (15%) of the gross income by the party obliged to pay:

(a) dividends paid or credited to a Timor-Leste resident company or resident person in connection in connection with profits arising with Petroleum Operations;
(b) dividends paid or credited to a Timor-Leste Permanent Establishment of a non- resident Australian person in connection with profits arising from Petroleum Operations;
(c) interest including premiums, discounts and compensation for loan repayment guarantee paid by a Contractor or Subcontractor to a Timor-Leste resident person;
(d) royalties, except those paid or credited by a Contractor or Subcontractor to a Timor-Leste non-resident person, being an Australian resident and which is subject to withholding tax at 10%; and
(e) royalties credited by a Contractor or Subcontractor to a Timor-Leste non-resident person, other than an Australian resident and which is subject to withholding tax at 13.5%.

Interest payments on loan repayment guaranteed paid by a Contractor or Subcontractor to a Timor-Leste P.E of a non-resident person, being an Australian resident shall be subject to ten percent (10%) withholding tax, and thirteen and a half (13.5%) in all other cases, other than as stipulated in Section 28A(c).

Section 28B

Dividends, other than in circumstances specified under Section 28A above, in whatever name or form, paid by or due from a Timor-Leste resident company and Timor-Leste P.E of a non-resident person out of JPDA profits to:

(a) a Timor-Leste P.E. of a non-resident person, other than an Australian resident person;
(b) a Timor-Leste P.E. of a company that is not a resident of Australia; and

(c) Timor-Leste P.E. of a non-resident person

shall be subject to withholding tax of thirteen and a half percent (13.5%) of the gross income by the party obliged to pay:

Section 28C

Other Withholding Taxes

The following category of payments is subject to withholding tax as the rates specified below:

(a) gifts and rewards to employees by employers, other than those on which an employee income tax has been withheld are hereby subject to withholding tax at thirteen and a half percent (13.5%);

(b) payments made in connection with drilling or in support of drilling by a Contractor is subject to a withholding tax at 5.4% within the JPDA (except Annex F) and 6% within the Timor-Leste Exclusive Area

(c) rental payments for lease of land or building made to a natural person by a Contractor or Subcontractor carrying on Petroleum Operations in the JPDA (except Annex F) shall be subject to withholding tax at nine percent (9%), and when made by a Contractor or Subcontractor within the Timor-Leste Exclusive area shall be subject to withholding tax at ten percent (10%);

(d) rental or lease payments in connection with the use of properties within the JPDA (other than in Annex F) is subject to withholding tax at 5.4 %, similar payment in respect of similar properties within the Timor-Leste Exclusive Area is subject to withholding at six percent (6%);

(e) drilling services and drilling support services, other than those performed by a Timor-Leste Permanent Establishment within or without the JPDA (except Annex F) is subject to withholding at 5.4%, similar payment for similar services is subject to six percent (6%) when performed within the Timor-Leste Exclusive Area,

(f) rental payments for lease of land or building made to a legal owner other and or a natural person by a Contractor or Subcontractor carrying on Petroleum Operations in the JPDA (except Annex F) shall be subject to withholding tax at nine percent (9%), and when made by a Contractor or Subcontractor within the Timor-Leste Exclusive area whether legal or natural person, shall be subject to withholding tax at ten percent (10%);

(g) payment made by a Contractor or Subcontractor carrying on business within the JPDA (except Annex F) in respect of shipping services commencing and ending in Timor-Lester or anywhere is subject to a withholding tax at 5.4% ;

(h) payment made by a Contractor or Subcontractor carrying on business within the Timor-Leste Exclusive Area in respect of shipping services commencing and ending in Timor-Leste or anywhere else is subject to a withholding tax at 6%;

(i) payment made by a Contractor or Subcontractor carrying on business within the JPDA (except Annex F) in respect of air transportation services commencing and ending in Timor-Lester or anywhere is subject to a withholding tax at 5.4% ;

(j) payment made by a Contractor or Subcontractor carrying on business within the Timor-Leste Exclusive Area in respect of air transportation services commencing and ending in Timor-Leste or anywhere else is subject to a withholding tax at six percent (6%);

(k) payment made by a Contractor or Subcontractor carrying on business within the JPDA a (except Annex F) in respect of construction services and or construction consulting

services is subject to a withholding tax at 5.4%, payment for similar services within the Timor-Leste Exclusive Area is subject to withholding tax at six percent (6%);

(l) payment received for the performance of technical services, management services, accounting, bookkeeping legal, tax consulting, brokerage, appraisal, actuary, film dubbing/mixing, manpower supply, pest control, cleaning services, logging and timber cutting within the JPDA (except Annex F) is subject to withholding tax at 5.4%, similar payment for similar services within the Timor-Leste Exclusive Area is subject to withholding tax at six percent (6%);

(m) payment received for the performance of architectural services, interior services and landscape design within the JPDA (except Annex F) is subject to withholding tax at 5.4%, similar payment for similar services within the Timor-Leste Exclusive Area is subject to withholding tax at six percent (6%); and

(n) payment for any other services not specifically mentioned above and procured in connection with Petroleum Operations within the JPDA (except Annex F) and the Timor-Leste Exclusive Area is subject to six percent (6%) withholding tax.

Section 29

Obligations of a Person Withholding Tax from a Payment

29.1

A Contractor or Subcontractor who has the obligation to withhold tax under Sections 26, 28 and of 28A of the present Regulations and Sections 81and 72.2 of the Taxes and Duties Act and who has withheld tax accordingly, shall remit the tax withheld to the Petroleum Fund account held by the Timor-Leste Central Bank within fifteen (15) days after the end of the month in which the payment was made.

29.2

At the time of the payment, the payer must issue to the recipient of the payment a withholding tax notice setting out the amount of the payment made and the amount of tax withheld from such payment.

29.3

A contractor or Subcontractor who fails to withhold tax in accordance with any enabling laws or under the present Regulations from a payment made by the person is personally liable to pay the amount of the tax which has not been withheld to the Timor-Leste Central Bank

29.4

A Contractor or Subcontractor who has been personally held liable under subparagraph 28.3 above and who has made a payment of the tax due to the Central Bank is entitled to recover the amount of the tax from the recipient of the payment in respect of which he failed to withhold tax.

29.5

For the limited purpose of Sections 26, 28 and 28A of the present Regulations, the Contractor or the Subcontractor withholding tax under the present Regulations and or the Taxes and Duties Act, shall be treated as an agent of the Tax Administration to the extent of such taxes withheld. In the event of the liquidation, merger, acquisition or bankruptcy of the person holding or having control over the tax withheld, the Tax Administration and or the Government of Timor-Leste

shall have a first claim of right to the tax withheld before any distribution or transfer of property is made.

29.6
The legal regime applicable in relation to the collection and recovery of tax shall apply to any amount withheld or required to be withheld in accordance with this Section.

29.7
The provisions of Sections 72 to 74 of the UNTAET Regulation 2000/18 may be applied by the Tax Administration to any understatement or underpayment in respect of any tax owed and which is connected with withholding tax obligations of any person.

Chapter V

Section 30
Annual Income Tax Return

The following persons are required to deliver a completed annual income tax form to the Tax Administration in the manner prescribed by the Commissioner:

(a) person who is required to pay income tax under the present Regulations and UNTAET Regulation 2000/18 in connection with matters covered by and subject to Chapter IX of the Taxes and Duties Act;
(b) any person receiving an amount that has not been correctly subject to withholding tax, where applicable under the present Regulations and UNTAET Regulation 2000/18 in connection with matters covered by and subject to Chapter IX of the Taxes and Duties Ac; and
(c) other persons or classes of persons as may be designated by the Tax Administration from time to time.

30.1
An income taxpayer required to deliver a completed income tax form for a tax year to the Tax Administration shall deliver the form not later than the last day of the third-month, following the end of the tax year.

30.2
A completed income tax return of a Contractor shall include:

(a) a completed annual income tax form designated by the Tax Administration, including any additional information and or documents required on the face of the form;
(b) profit and loss statement;
(c) book to tax reconciliation;
(d) balance sheet, including information on any change in equity section from the previous year;
(e) depreciation schedules; and

(f) description of related party transactions, including amounts and the nature of the transaction, organizational chart.

30.2
A completed income tax return of a Subcontractor shall include:

(a) a completed annual income tax form designated by the Tax Administration, including any additional information required on the face of the form;
(b) profit and loss statement;
(c) book to tax reconciliation;
(d) balance sheet, including information on any change in equity section from the previous year; and
(e) description of related party transactions (where necessary); including amounts and the nature of the transaction, organizational chart.

30.3
A Contractor or Subcontractor may apply to the Tax Administration for an extension of time to deliver the annual income tax form required under this Section. The application for such an extension of time must be signed by an officer of the taxpayer and the basis of the application must be clearly stated.

30.4
An application made pursuant to subparagraph 30.3 above must be accompanied by proof of payment of the tax due in full and a calculation of the estimated tax due.

30.5
The Tax Administration may, by notice in writing, grant the application for extension of time to deliver the annual income tax form upon certain terms and conditions. The granting of an extension to file the income tax return under this Section does not alter the due date for the payment of the tax due.

30.6
The income tax due from a Contractor or Subcontractor and or any other person for a tax year is due and payable not later than the last day of the third-month, following the end of the tax year.

Section 31
Contractor's Monthly Income Tax Obligations

31.1
With respect to a Contractor's first year, the Contractor shall provide an estimate of the projected tax liability to the Tax Administration not later than the 15th day of the month following the first period of thirty (30) consecutive days during which the average level of regular production delivered for sale on the twenty five (25) highest days in the thirty-day period reaches a level of regular production delivered for sale as determined by the Tax Administration.

31.2
The projected tax liability of a Contractor for the first tax year as determined pursuant to subparagraph 31.1 shall be divided by twelve (12) and the Contractor shall pay a monthly instalment of one-twelfth ($1/12^{th}$) on the fifteenth ($15^{th)}$ day of each month in the first tax year.

31.2
A contractor is liable for monthly instalments of estimated income tax for each tax year. The monthly instalment is due and payable on the fifteenth (15th) day following the month to which they relate.

31.3
Excepting where the Tax Administration decides otherwise and or the Contractor's first tax year as determined under subparagraph 31.1 above, the amount of each estimated monthly tax liability of a Contractor shall be equal to one-twelfth ($1/12^{th}$) of the Contractor's income tax liability for the preceding tax year. The amount of instalment due before the due date for the delivery of the Contractor's income tax return for the preceding year shall be the higher of:

(a) the amount of the instalment paid in for the last month of the preceding tax year; or

(b) the average monthly tax instalment payment for the preceding tax year.

31.3(a)
If in the opinion of a Contractor the use of the prior year tax liability is unlikely to accurately predict the current year liability and lead to a material underpayment of the income tax liability for the current tax year, the Contractor may, by an application made to the Commissioner submit a different estimated tax liability. There is a material underpayment of income tax liability where the monthly tax payments made for a tax year is less than 90% of the actual tax liability for the tax year.

31.3(b)
Upon the approval of the application made by a Contractor under subparagraph 31.3(a) of the present Regulations by the Commissioner, the new estimated tax liability shall form the basis of the subsequent monthly tax obligations of the Contractor. Any underpayment of tax for prior periods preceding the date of the substituted estimated tax liability of a Contractor must be paid in full within five (5) business days from the date the Contractor is notified in writing of the approval of the substituted estimated tax liability by the Commissioner.

31.4
The amount of tax instalment due and payable under this Section and Section 82 of the Taxes and Duties Act may be determined by the Tax Administration, where:

(a) a contractor has a loss carried forward for the preceding tax year;

(b) a Contractor derives irregular income;

(c) the income tax return of a Contractor for the preceding tax year is delivered after the due date, inclusive of any extension of time grated pursuant to Section 30.5 of the present Regulations;

(d) there is a material change in the Contractor's circumstances, including merger or acquisition or a natural disaster;

(e) a contractor's income tax return for the preceding year is amended, either as a result of a tax audit or self-amendment; and

(f) a Contractor fails to provide the Tax Administration with estimated income tax liability as required under Section 31.1 above and under Section 82.5 of the Taxes and Duties Act.

31.5
An estimated tax liability previously provided to the Tax Administration may be revised by the Contractor, provided the consent of the Tax Administration is sought and obtained in advance. An estimate of tax liability delivered to the Tax Administration, including any revised version is valid for the entire tax year.

31.6
Any amounts of underpayment arising pursuant to a revised calculation of the estimated tax liability of a Contractor under subparagraph 31.5 above shall become due and payable together with the first instalment due after the revised estimate is approved by the Tax Administration. If there is an overpayment of tax arising from the revised estimate, such overpayment shall be applied as a credit against future monthly income tax liability of the Contractor.

31.7
If a Contractor's estimate made under subparagraph 31.2, including any revised estimate of income tax for the Contractor's first year is less than ninety (90) percent of the Contractor's tax actual liability arising from a self-assessment and or tax audit, the Contractor shall be liable for penalty equal:

(a) if the under-estimate is due to fraud or willful neglect, fifty (50) percent of the difference between the estimated tax liability and the actual tax liability (hereinafter called "the tax shortfall";

(b) in any other case, ten (10%) of the tax shortfall.

31.8
If the Tax Administration is satisfied that the reason for the shortfall was due to circumstances beyond the Contractor's control, such as natural disaster, material and or significant price fluctuations, and that the Contractor exercised all diligent and reasonable care in making the estimate, the tax penalties imposed pursuant to subparagraphs 31.1(a)-(b) may be waived.

Chapter VI

Section 32
Supplemental Petroleum Tax

32.1
Pursuant to Section 83.1 of the Taxes and Duties Act, a Contractor subject to Supplemental Petroleum Tax in a tax year shall determine such tax liability according to the following formula:

A x 22.5%/(1-r)

Where:
A:is the Contractor's accumulated net receipts for Petroleum Operations income for the tax year; and
r: is the corporate tax rate (30%) as stipulated in Section 72.1 of the Taxes and Duties Act.

32.2
The Supplemental Petroleum Tax under Section 83 on a Contractor for a tax year is a separate tax from the corporate income tax imposed under Section 72.1 and it is an addition to corporate income tax, where applicable.

32.3
The Supplemental Petroleum Tax paid by a Contractor in a tax year is an allowable deduction for the purposes of calculating the corporate income tax payable for the year in which both the corporate income tax and the Petroleum Supplemental Tax were paid.

Section 33
Accumulated Net Receipts

33.1
The accumulated net receipts of a Contractor shall be determined in accordance with the formula prescribed in Section 84.1 of the Taxes and Duties Act, namely:

((Ax116.5%) – (1x (1-r))) + B

Where:

A:
is the Contractor's accumulated net receipts for Petroleum Operations at the end of the previous tax year;
B :
is the Contractor's net receipts for Petroleum Operations for the current tax year;

1:
is the interest expense and other financial charges paid by the Contractor in respect of Petroleum Operations in the current tax year and is entered as a negative number in the formula above; and

r
is 30% (being the corporate income tax rate specified in Section 72.1) of the Taxes and Duties Act.

33.2
In a year in which a Contractor is liable for the Supplemental Petroleum Tax as determined under the present Regulations and Section 83.2 of the Taxes and Duties Act, for the purposes of calculating the accumulated net receipts of the Contractor for the Petroleum Operations for the next tax year, the amount of the accumulated net receipts shall be nil.

33.3
In a tax year in which (**A x 116.5%**) component of the formula described in subparagraph 33.1 above and Section 84.1 of the Taxes and Duties Act is negative, the subtraction of (**1 x(1-r**) component of the formula shall not operate in a manner to reduce the amount of **((Ax116.5%) – (1x (1-r)))** to an amount that is less than the value of **A** component of the formula.
There shall be no carryover or carryback of any excess resulting from the application of the formula to a Contractor in any tax year.

Section 34
Contractor's Net Receipts

For the purposes of the Supplemental Petroleum Tax, the net receipts of a Contractor in respect of Petroleum Operations for a tax year is gross receipts of all includible income of the Contractor for the year less the total allowable deductible expenditures of the Contractor in respect of Petroleum Operations for the year.

Section 35
Gross Receipts

35.1
For the limited purposes of gross income in relation to the computation of the Supplemental Petroleum Tax of a Contractor in a given tax year, the gross receipts of a Contractor arising from Petroleum Operations, is the aggregate of the following amounts:

(a) all income items under Section 8 of the present Regulations earned or accrued in the year in connection with or from Petroleum Operations but excluding interest income, earned or accrued during the tax year;
(b) any consideration received by the Contractor in the year and in respect of the disposal, transfer, alienation or destruction, or loss of property, including materials, equipment, plant facilities, intellectual property or rights used in Petroleum Operations, if the expenditure incurred in acquiring the property has been in deducted in computing the net receipts of the Contactor for any tax year;
(c) any amount received by the Contractor in the tax year in respect of the provision of information and or data obtained from any survey, appraisal, or study in connection with Petroleum Operations where the related expenditure incurred in undertaking the survey, appraisal, or study has been deducted in computing the net receipts of the Contractor for any tax year;

(d) any amounts received by the Contractor in the tax year that is a reimbursement, refund or other compensation for an amount previously deducted in computing the net receipts of the Contractor for any tax year; and
(e) any compensation, indemnity and or damages received from an insurance policy or similar instruments, indemnity agreement, settlement or judicial decision by a Contractor in respect of any property used in Petroleum Operations where such property was destroyed and or damaged.

35.2
Subject to the provisions of Section 88 of the Taxes and Duties Act, an amount received or accrued as consideration for the transfer of an interest in Petroleum Operations is excluded from the computation of the gross receipts of a Contractor under subparagraph 34.1 of the present Regulations.

35.3
For the limited purpose of calculating the net receipts of a Contractor in a tax year, the amounts includible as part of the gross receipts of a Contractor under subparagraph 34.1 is limited to the portion of such amounts attributable to the Petroleum Operations of the Contractor.

Section 36
Deductible Amounts for Supplemental Petroleum Tax

For the limited purposes of calculating the Supplemental Petroleum Tax imposed under Section 83 of the Taxes and Duties Act 2008 (including amendments), for the current year, a Contractor may deduct the following items:

(a) permissible deductible expenditures incurred by the Contractor in the current year in respect of the Petroleum Operations, excluding the amounts allocable to depreciation and or amortisation deductions, interest and other financing charges;
(b) capital expenditure incurred in the current year in respect of acquisition or construction of a tangible or intangible asset for use in the Petroleum Operations in which the Contractor is engaged in a Contract Area, excluding an amount paid as consideration by a Contractor for the acquisition of an interest in Petroleum Operations;
(c) exploration expenditure incurred by the Contractor in the current year in respect of the Petroleum Operations in which the Contractor is engaged in a Contract Area; and
(d) an amount of Timor-Leste corporate income tax calculated by applying the rate specified in Section 72 of the Taxes and Duties Act to the taxable income of the Contractor, excluding any additional taxes or interest imposed under Sections 72-74 of the UNTAET Regulation 2000/18, or under the present Regulations.

36.1
The amounts deductible under subparagraphs (a)-(d) are limited to those directly attributable to the Petroleum Operations of the Contractor and in respect of a Contract Area.

Section 37

Any consideration, including all transactions costs paid or accrued by a Contractor in respect of the acquisition of an interest in Petroleum Operations under Section 88 shall be excluded from the permissible deductible expenditure under Section 36 of the present Regulations and Section 87.1 of the Taxes and Duties Act.

Section 38

Annual Supplemental Petroleum Tax Return

38.1

Every Contractor having a Supplemental Petroleum Tax obligation under Section 32 of the present Regulations and Section 83 of the Taxes and Duties Act Tax shall deliver a completed annual Supplemental Petroleum Tax return form to the Tax Administration in the manner prescribed by the Commissioner.

38.2

Any Contractor required to deliver a completed annual Supplemental Petroleum Tax return form to the Tax Administration shall deliver the form not later than the last day of the third-month, following the end of the tax year to which the tax form relates.

38.3

A completed annual Supplemental Petroleum Tax return of a Contractor means a completed annual Supplemental Petroleum Tax return form designated by the Tax Administration, including any additional information and or documents required on the face of the form, or by the Tax Administration.

38.4

A Contractor may apply to the Tax Administration for an extension of time to deliver the annual Supplemental Petroleum Tax return form required under this Section. The application for such an extension of time must be signed by an officer of the taxpayer and the basis of the application must be clearly stated.

38.5

An application made pursuant to subparagraph 38.4 above must be accompanied by proof of the payment of the tax due in full and a calculation of the estimated tax due.

38.6

The Tax Administration may, by notice in writing, grant the application for extension of time to deliver the annual Supplemental Petroleum Tax return form upon certain terms and conditions. The granting of an extension to file the Supplemental Petroleum Tax return under this Section does not alter the due date for the payment of the tax due.

38.7

The Supplemental Petroleum Tax return due from a Contractor for a tax year is due and payable not later than the last day of the third-month, following the end of the tax year to which the tax relates.

Chapter VII

Section 39

Contractor's Monthly Income Tax Obligations

39.1
Every Contractor having a Supplemental Petroleum Tax obligation under Section 32 of the present Regulations and Sections 83 and 90 of the Taxes and Duties Act Tax shall be liable for monthly instalments of Supplemental Petroleum Tax.

39.2
Every Contractor having a Supplemental Petroleum Tax obligation under Section 32 of the present Regulations and Section 83 and 90 of the Taxes and Duties Act Tax shall deliver to the Tax Administration an estimate of Supplemental Petroleum Tax due for a tax year not later than the due date for payment of the first Supplemental Petroleum Tax instalment due for that tax year.

39.3
The estimated Supplemental Petroleum Tax liability of a Contractor for a tax year as determined pursuant to subparagraph 39.2 shall be divided by twelve (12) and the Contractor shall pay a monthly instalment of one-twelfth ($1/12^{th}$) on the fifteenth (15th) day of each month following the month in which they relate.

39.4
Where the first obligation of a Contractor under Section 32 of the present Regulations and Section 90 commences in a month other than the month of January, the monthly instalments due and payable by the Contractor under subparagraph 39.3 above shall be calculated by dividing the remaining month(s) of that tax year by the estimated Supplemental Petroleum Tax determined under subparagraph 39.2 of the present Regulations.

39.5
Excepting where the Tax Administration decides otherwise and or the Contractor's first Supplemental Petroleum Tax obligation commenced in a month other than the month of January in a tax year, the amount of each estimated monthly Supplemental Petroleum Tax liability of a Contractor shall be equal to one-twelfth ($1/12^{th}$) of the Contractor's Supplemental Petroleum Tax liability for the preceding tax year. The amount of instalment due before the due date for the delivery of the Contractor's Supplemental Petroleum Tax return for the preceding year shall be the higher of:

(c) the amount of the instalment paid in for the last month of the preceding tax year; or

(d) the average monthly tax instalment payment for the preceding tax year.

39.6
The amount of tax instalment due and payable under this Section and Section 90 of the Taxes and Duties Act may be determined by the Tax Administration, where:

(a) the annual Supplemental Petroleum Tax return of a Contractor for the preceding tax year is delivered after the due date, inclusive of any extension of time grated pursuant to Section 38.6 of the present Regulations;

(b) there is a material change in the Contractor's circumstances, including merger or acquisition or a natural disaster;

(c) a contractor's Supplemental Petroleum Tax return for the preceding year is amended, either as a result of a tax audit and or self-amendment; and

(d) a Contractor fails to provide the Tax Administration with estimated Supplemental Petroleum Tax liability as required under Section 39.2 above and under Section 90.2 of the Taxes and Duties Act.

39.7
An estimated Supplemental Petroleum Tax liability previously provided to the Tax Administration may be revised by the Contractor, provided the consent of the Tax Administration is sought and obtained in advance. An estimate of tax liability delivered to the Tax Administration, including any revised version is valid for the entire tax year.

39.8.
Any amounts of underpayment arising pursuant to a revised calculation of the estimated tax liability of a Contractor under subparagraph 39.7 above shall become due and payable together with the first instalment due after the revised estimate is approved by the Tax Administration. If there is an overpayment of tax arising from the revised estimate, such overpayment shall be applied as a credit against future monthly Supplemental Petroleum tax liability of the Contractor.

39.9
If a Contractor's estimate made under this Section and Section 90 of the Taxes and Duties Act in respect of the Supplemental Petroleum Tax obligation of a Contractor, including any revised estimate, is less than ninety (90) percent of the Contractor's tax actual liability arising from a self-assessment and or tax audit, the Contractor shall be liable for penalty equal to:

(a) if the under-estimate is due to fraud or willful neglect, fifty (50) percent of the difference between the estimated tax liability and the actual tax liability (hereinafter called the "SPT shortfall"; or

(b) in any other case, ten (10%) of the SPT shortfall.

39.10
If the Tax Administration is satisfied that the reason for the SPT shortfall was due to circumstances beyond the Contractor's control, such as natural disaster, material and or significant price fluctuations, and that the Contractor exercised all diligent and reasonable care in making the estimate, the tax penalties imposed pursuant to subparagraphs 39.9(a)-(b) may be waived.

Section 40
UNTAET Regulation 2000/18

Other administrative matters not expressly covered under the present Regulations, including but not limited to tax appeals shall continue to be governed by the UNTAET Regulations 2000/18.

Chapter VIII

Section 41
Tax Audit

(a) the Tax Administration shall conduct periodic tax audits to test tax compliance and for other lawful purposes in the context of implementing and enforcing relevant provisions of tax laws;

(b) a tax audit is commenced with an official tax audit notification issued by the Tax Administration and delivered to taxpayer, or the taxpayer's representatives, as the case may be;

(c) a taxpayer under tax audit shall, upon request by the Tax Administration;

i. show and or submit books and records, or copies thereof, documents and or information specifically requested by the Tax Administration and forming the basis of the book and records, documents pertaining to income received, expenditures incurred, business activities, independent work of the taxpayer or the independent work performed for the taxpayer; and

ii. grant access to enter such places or offices, factory, installations, platforms, Contract Area as is deemed necessary and material to carrying out the audit;

iii. Tax audits shall be undertaken on the basis of an annual plan, adopted by the Tax Administration, based on the tax risk profile and the significance of the taxpayer. When adopting the plan, the evaluation of the effect of tax audit and control on the efficiency of tax collection in relation to Petroleum Operations in future periods shall also be taken into consideration.

Section 42
Tax Audit Methods

Tax audit methods shall include:

(a) desk or office controls;
(b) field controls; and
(c) referrals to the Prosecutor General's office with a view of determining the commission of a tax-related offense.

Section 43

Office Control

Office control is a set of actions by means of which the Tax Administration verifies the accuracy, completeness, truthfulness and legal base of the data shown in tax returns of whatever description, as well as the tax balances, accounting statements and other statements or positions of the taxpayer, comparing the said data to data from tax accounting records and other official records kept by, or at the disposal of, the Tax Administration.

Office controls shall be undertaken in the premises of the Tax Administration by tax auditors or inspectors and or lawyers.

Section 44

Processing of Tax Returns and other Statements of the Taxpayer

During the procedure of office controls of receipt and processing of a tax return:

(a) the verification of the mathematical accuracy, formal accuracy and completeness or truthfulness of the tax return and other statements filed by the taxpayer is performed by the Tax Administration in accordance with the all the applicable Laws;

(b) if during the processing of tax return and other statements a mathematical error is detected, the Tax Administration shall correct such error and notify the taxpayer immediately to pay any difference or determine the amount of tax refund;

(c) if during the processing of the tax return and other statements it is determined that they are formally incorrect, incorrectly filled out or incomplete, the tax auditor or inspector shall by a written notification instruct the taxpayer to remove any error or complete the tax return and other statements within fourteen (14) days; and

(d) if the taxpayer does not proceed in accordance with the written instruction as indicated in subparagraph c above, it shall be considered that the tax return or other statements, as the case may be, were not filed with the Tax Administration.

Section 45

Participation of a Taxpayer in Office Control Procedure

The taxpayer under tax audit shall be under the obligation to participate, directly or through a tax representative, in furtherance of the desk or office control tax audit, at a request from the Tax Administration, and to give the requested explanations, documentations or information within the term specified by the Tax Administration. The failure of the taxpayer to respond is not a bar to further the desk or office tax audit in any manner determined by the Tax Administration until the process is completed in accordance with the applicable tax laws.

Section 46
Change of Tax Liability upon Findings of Desk/Office Controls

(a) if there is a change of the amount of tax liability during the procedure of desk or office control, the tax auditor or inspector shall be under the obligation to prepare a report of the summary of the facts and the findings in triplicates;

(b) a copy of the summary report provided under subparagraph (a) shall be sent to the taxpayer within ten (10) business days from the date of the report;

(c) the taxpayer shall have a right to file an objection against the report within five (5) business days after the receipt of the report. The objection must clearly state the ground(s) and the relief sought from the Tax Administration;

(d) the tax Administration is required to review the objection and make a determination within thirty (30) days from the date of the receipt of the objection;

(e) if the objection filed by the taxpayer pursuant to subparagraph (c) above is granted, the Tax Administration shall issue a "No further action required" letter to the taxpayer within forty-five (45) days; and

(f) if the objection filed by the taxpayer pursuant to subparagraph (c) above is dismissed, the Tax Administration shall issue a tax assessment accordingly, and the procedure set out in Section 69 of UNTAET Regulation 2000/18 in respect of tax appeals shall apply thereafter.

Section 47
Field Audit Controls

(a) field audits shall be undertaken within the premises of the taxpayer in Timor-Leste and or the offices of the Tax Administration or another location in Timor-Leste as may be determined by the Commissioner;

(b) field control shall be undertaken by a team constituted for that purpose by the Tax Administration;

(c) field control shall be undertaken on the basis of a control order or notice issued by the Tax Administration;

(d) the Tax Administration may postpone the commencement of field control if the taxpayers submits a written complaint immediately upon the receipt of the control order indicated in subparagraph 47(c) above, and state the factual and the legal reasoning showing that the control or notice is contrary to Law. Such a complaint must be delivered to the Tax Administration within three (3) business day from the date of the receipt of the control order or notice stipulated in subparagraph 47(c); and

(e) a written decision on the complaint indicated in subparagraph 47(d) of the present Regulation shall be issued by the Tax Administration within fifteen (15) business days from the date of the receipt of the complaint. The decision of the Tax Administration shall be final and not subject to appeal.

Section 48

Location of Field Control

(a) the taxpayer shall be under the obligation, if the field control is conducted in a premises occupied, owned, leased on controlled by the taxpayer under tax audit, to designate an appropriate working area at the disposal of the tax auditors, inspectors and or their representatives;

(b) the auditors, inspectors and representatives of the Tax Administration shall have the right to enter into the places indicated in subparagraph (a) where the taxpayer may be conducting its business;

(c) the taxpayer or a representative of the taxpayer with a valid power of attorney may be present at all times during the inspection of the books and records of the taxpayer by the auditors, inspectors and their representatives;

(d) if the taxpayer or representatives of the taxpayer are not present and the Tax Administration is prevented or delayed because of the absence of the taxpayer and or the representatives, a notation must be made accordingly in the audit record;

(f) if the field control is not conducted in the business premises of the taxpayer, the auditor, inspectors and or the representatives of the Tax Administration may inspect the taxpayer's business premises and enter the report of the inspection in the audit records; the taxpayer shall be under the obligation to participate in the fact finding process relevant to taxation in such manner as to give information and statements at the written request of the Tax Administration;

(g) the taxpayer shall be under the obligation to enable the tax auditors, inspectors and the representatives of the Tax Administration to obtain copies of relevant documents and or samples of goods;

(h) if the taxpayer is unable to attend the field control, the taxpayer shall delegate a person to act as his agent or representative;

(i) the failure and or neglect of the taxpayer to meet the obligation under subparagraph (h) above shall not delay the field audit;

(j) the auditors, inspectors and or representatives of the Tax Administration may by writing request data or control of documentation from employees of the taxpayer or other persons; and

(k) the employees and other referred to in subparagraph (j) above shall be under the obligation to make the information or documentation at their disposal available to the Tax Administration.

Section 49

Time of Field Control

Where a field control is conducted at the premises of the taxpayer, it shall be conducted only during the working hours of the taxpayer, and exceptionally after working hours as well, if the purpose of the control requires this and if the taxpayer consents.

Section 50

Report

(a) at the conclusion of a tax audit or any material part of thereof, the Tax Administration shall prepare a final report of the field control;

(b) every page of the report must be marked by serial number and be signed ;

(c) a copy of the field control report shall be delivered to the taxpayer within twenty one (21) business days from the date of completion of the report by the Tax Administration;

(d) the taxpayer may submit a written objection against the report of the field control within five (5) business days from the date of the receipt from the Tax Administration;

(e) the Tax Administration must review the taxpayer's complaint and if in the opinion of the Tax Administration there is new evidence and facts in the complaint that is sufficient to alter the factual and or legal basis of the report or any material parts thereof, the Tax Administration shall prepare additional report on such new evidence and or facts or of new legal evaluations and provide a copy to the taxpayer within fifteen (15) business days; and

(f) if it is determined on the basis of the report or additional report on field control that there is no basis for amending the tax liability, the taxpayer shall be informed in writing, within thirty (30) days from the date of delivering the report, or the additional report, as the case may be.

Section 51

NDPR Public Ruling 2011/02

Where relevant, NDPR Public Ruling 2011/02 shall apply to the calculation of the income tax (including value of pre-commercial discovery expenditure) and the Supplemental Petroleum Tax obligations of a Contractor ***mutatis mutandi*** in respect of all items of income and expenditure of a Contractor.

Section 52
Commencement Date

The provisions of this Regulations shall be applied retroactively from January 1, 2012 and is effective for tax year commencing on or after January 1, 2011

Issued under my hand in exercise of my administrative and statutory authority in relation to taxation matters in Timor Leste, this 26th day of June, 2012.



Her Excellency Emilia Pires
Minister of Finance
Timor-Leste

(Taxation of Bayu-Undan Contractors) Regulations, 2013

Interpretation

Chapter I

Section 1

Preamble & Purposive interpretation & Short Title

Where Sections in the present Regulation are capable of alternative interpretations, the interpretation that best achieves the intended purpose of the Taxation of Bayu-Undan Contractors Act, Law No. 3/2003 shall be adopted and any interpretation that frustrates the intended purpose of the legislation or impedes the right of Timor-Leste to collect the tax revenue accruing from Petroleum Operations in accordance with the applicable tax laws, including Treaties shall be rejected.

The present Regulations shall be referred to as TBUCA Regulations/19-2013

Section 2

Definitions extend to other forms of words

2.1 Definitions in the present Regulations in the singular form shall be read as applying to the plural form and definitions in the plural form shall be read as applying to the singular form as appropriate.

2.2 Definitions in the present Regulations in the masculine form shall be read as applying to the feminine form and definitions in this section in the feminine form shall be read as applying to the masculine form.

Section 3

Scope of Regulations

The present Regulations shall apply to the territory of Timor-Leste, including its territorial sea, and to its exclusive economic zone and continental shelf where, by international law, Timor-Leste has sovereign rights for the purposes of exploration for and exploitation of its natural resources and applies only in the area covered by the Production Sharing Contracts described in Annex F of the Timor Sea Treaty, namely: Production Sharing Contracts JPDA 03-12 and JPDA 03-13, inclusive of amendments and annexes to the contracts stipulating the natural gas valuation.

The present Regulations shall apply to a Contractor and Subcontractor (where appropriate) in connection with Petroleum activities or Petroleum Operations in the limited area described and designated as Annex F in the Timor Sea Treaty.

Section 4
Definitions

In the present Regulation:

"**Accounting**" means a systematic process under the IFRS or a Generally Accepted Accounting Practice, of recording of data and information in respect of assets, liabilities or debt, equity, income and expenditures, and all outlays associated with the acquisition and delivery of goods and services, resulting in a financial report in the form of a balance sheet and profit and loss statement at end of each reporting period

"**Affiliate**" means in respect of a Contractor (or, if more than one person, in respect of each such person), a person that controls, is controlled by, or is under common control with the Contractor;

"**Associate**" in relation to a person means any other person who acts or is likely to act in accordance with the wishes of the person as a result of a connection between the persons or common ownership or control; it includes:

a) A natural person and a relative of the natural person;
b) A legal person and any person who owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in the legal person; or
c) Two or more legal person if a third owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in each person;

"**Amount**" includes any value in kind or cash;

"**Air or Sea Transportation Services**" means any transportation of passengers, mail, or goods by air or sea:

a) between two places in Timor-Leste;
b) From a place in Timor-Leste to a place outside Timor-Leste;
c) From a place outside Timor-Leste to a place in Timor-Leste

"**Annual Tax Return**" means a form used by a taxpayer to report the calculation and/or payment of tax due within a tax year as prescribed by the Commissioner and or the Tax Administration;

"**Approval**" means a written authorization by the authorizing organization, body or person;

"**Approved Contract**" means a contract made by the Contractor and approved by the responsible Ministry or Designated Authority, as the case may be, as part of a Development Plan;

"**Arm's Length Transaction**" means transactions in which the conditions and or terms imposed between two related parties or associates in their commercial or financial relations are similar to those which would be made between independent and unrelated enterprises;

"**Audit**" means a series of activities to seek, gather and process data, documents and or information for tax compliance purposes;

"**Bank**" means any legal person licensed to accept deposits, and using such funds, either in whole or in part, to make extensions of credit or investments for the account, and at the risk, of the person carrying on the business;

"Bayu-Undan" is the discovered part of the Bayu-Undan field, as defined and designated in the Production Sharing Contracts JPDA 03-12 and JPDA 03-13;

"**Board**" means the Board of Tax and Customs Appeals established under the UNTAET Regulation 2000/18, including any amendments;

"**Body**" means a type of business organization which may be a limited company, limited partnership, an enterprise owned by the government in whatever name and form, association, cooperative, joint venture or similar arrangement, permanent establishment and other such business enterprise;

"**Carry Forward Loss**" means a loss carried forward under Article 6(2) of the Law on Income Tax;

"**Code**" means the Petroleum Mining Code agreed and adopted by Timor-Leste and Australia under Article 7 of the Timor Sea Treaty, as amended, varied, modified, or replaced from time to time, and the regulations or orders made thereunder;

"**Commissioner**" means the Commissioner or the Director General of the Directorate of Revenue of the Ministry of Finance, Timor-Leste;

"**Contract Area**" means the area that is subject of a Petroleum Agreement and, if any part of a Contract Area is relinquished pursuant to a Petroleum Agreement, the Contract Area is the Contract Area originally granted;

"**Contractor**" means a person deemed to be a taxpayer who:

(a) has entered into the Production Sharing Contract JPDA 03-12 or JPDA 03-13, or a Production Sharing Contract superseding the previous ones, in accordance with Annex F of the Timor Sea Treaty; or
(b) succeeds to a taxpayer mentioned in paragraph (a) above, or who is an assignee thereof, under the terms provided for by the Production Sharing Contract JPDA 03-12 and or JPDA 03-13, as the case may be., and who is registered as a contractor under the terms of the Petroleum Mining Code; and
(c) any other person who has entered into a Production Sharing Contract with the Designated Authority or the responsible Ministry, within the Annex F part of the JPDA;

"**Control**" means in relation to a person, the power of another person to secure:

a) by means of the holding of shares or the possession of voting power, in or in relation to the first person or any other person; or
b) by virtue of any power conferred by the articles of association of, or any other document regulating, the first person or any other person, that the affairs of the first person are conducted in accordance with the wishes or directions of that other person;

'**Controlled Taxpayer**" means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers;

"**Controlled transaction or controlled transfer**" means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term uncontrolled transaction means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers;

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"**Crude Oil**" means crude mineral oil and all liquid hydrocarbons in their natural state or obtained from Natural Gas by condensation or extraction;

"**Customs Controller**" means the Controller of the *Customs Service*;

"**Customs Service**" means the Timor-Leste Customs Service;

"**Customs Value**" means the fair market value of the *goods* including cost, insurance and freight as determined in accordance with article VII of GATT, or any amendments thereunder;

"**Deactivation Costs**" means the expenses approved under a Decommissioning Plan by the responsible Ministry or Designated Authority, as the case may be, under a Petroleum Agreement;

"**Deactivation Plan"** in respect of a petroleum project means, the Deactivation Plan approved in writing by the Designated Authority pursuant to the Production Sharing Contract that regulates a petroleum project, entered into between the Designated Authority and the Contractor;

"Depreciable Asset" means any tangible movable property that:
(a) has a useful life exceeding one year (12 months);
(b) is likely to lose value as a result of wear and tear, exploitation, or obsolescence; and
(c) is wholly or substantially used in the conduct of taxable activities;

"**Designated Authority**" means the Designated Authority established under Article 6 of the Timor Sea Treaty;

"**Designation Notice**" is a notice described in Section 68 of UNTAET Regulation 2000/18;

"**Development Expenditure**" means expenditure incurred, after the responsible Ministry or Designated Authority has approved a Development Plan, in preparing a site for Petroleum

Operations, including drilling and completing production wells, and the construction of production facilities, but does not include any expenditure incurred in the acquisition or construction of a pipeline or in the acquisition of a depreciable asset;

"**Development Plan"** in respect of a petroleum project means, a Development Plan approved by the Designated Authority pursuant to the Production Sharing that regulates a petroleum project, entered into between the Designated Authority and the Contractor

"**Dividend**" means any distribution of profit from current year or from accumulated earnings by a legal person to a member as a result of participation in the capital of the legal person, including:

a) Any amount returned to a member in respect of a membership interest in a legal person on a partial reduction in capital to the extent that the amount returned exceeds the amount or value by which the nominal value of the membership interest was reduced; or
b) Any amount distributed to a member on redemption or cancellation of a membership interest, including liquidation, to the extent the amount distributed exceeds the nominal value of the membership interest;

"Elang Kakatua Kakatua North" means the discovered area Elang Kakatua Kakatua North, as defined in Production Sharing Contract JPDA 03-12;

"**Exploration Expenditure**" means expenditure relating to and connected with geological, geophysical and geochemical surveys, exploration or appraisal drilling, or feasibility and environmental impact studies incurred in conducting Petroleum Operations prior to the grant of an approval of the Development plan by the responsible Ministry or Designated Authority, as the case may be;

"Export Pipeline" means an export pipeline as defined in the Production Sharing Contracts JPDA 03-12 and JPDA 03-13;

"**Field Export Point**" means the point at which petroleum from a Contract Area leaves the Contract Area, or such earlier point at which it is loaded onto or enters a vessel, pipeline, or other means of transportation to be transported from the Contract Area;

"**Financial institution**" means any licensed bank or other licensed legal person that is primarily engaged in the business of making credit extensions or investments for the account, and the risk, of the person carrying on the business;

"**Goods**" means any substance, organism, article or thing, whether manufactured or natural, which is not a human body, cadaver or human remains;

"**Head Office Expenditures**" means any executive, management, or general administration expenditures incurred by a non-resident person in the ordinary course of business, and which expenses are incurred solely and primarily for business purpose and for the benefit of the permanent establishment of the person in Timor-Leste;

"**Intangible Asset**" means any property, other than tangible movable or immovable property, that:

a) has a useful life exceeding one year;
b) is used wholly or substantially in the conduct of taxable business activities;

"**Intangible expenditure**" means any expenditure incurred other than in the acquisition of any tangible movable or immovable property, or tangible asset;

"**Interest**" means:

a) any amount (including a premium or original issue discount) paid or accrued under a debt obligation that is not a repayment of capital and pursuant to petroleum operations; or
b) any amount that is functionally equivalent to an amount referred to in paragraph (a), such as amount paid or accrued under an interest rate swap agreement or as defaulted under a guarantee agreement, pursuant to petroleum operations;
c) any commitment, guarantee, service, or similar fee payable in respect of a debt obligation or other instrument or agreement giving rise to interest under paragraphs (a) or (b);

"**International Financial Reporting Standards**" means the most recent International Financial Reporting Standards issued by the International Accounting Standards Board or any successor entity taking over the role of issuing International Financial Reporting Standards;

"Joint Commission" means the Joint Commission established pursuant to Article 6 of the Timor Sea Treaty;

"**Law on Income Tax**" means the Law on Income Tax, applicable in Timor-Leste as defined under UNTAET Regulation No. 1999/1

"**Law on Income Tax Regime and Procedures**" means the Law on the General Tax Regime and Procedures applicable in Timor-Leste, under the terms of the UNTAET Regulation No. 1999/1;

"**Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods**" means the Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods, applicable in Timor-Leste, under the terms of UNTAET Regulation No. 1999/1;

"**Legal Person**" means:

a) any limited liability company, joint stock company, general partnership, limited partnership, or other unincorporated association or body of persons, whether incorporated, formed, organized, or established in Timor-Leste or elsewhere;
b) any trust, undivided estate of a deceased natural person;

c) a government, a political or administrative subdivision of a government in whatever name or form, or public international organisation, or an entity, organisation, association, or business form owned by a government, political subdivision of a government, or public international organisation;

"**Long-Term Contract**" is a contract for manufacture, installation, maintenance, or construction, or services related thereto, that is not completed in the tax year in which work under the contract commenced, other than a contract estimated to be completed within six months of the date on which work under the contract commenced;

"Management Services" means the provision of managerial services, consulting, supervisory or other similar services for a fee between related parties;

"**Member**" in relation to a legal person means a shareholder, partner in a partnership, or any other person with a membership interest in a legal person;

"**Method of Accounting**" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item;

"**Mining**" means any method or process by which any mineral is taken from the soil or from any substance or constituent of the soil;

"**Mining Support services**" means every service relating to mining other than technical, management, consulting, or architectural services;

"**Natural Gas**" means all gaseous hydrocarbons and inerts, including wet mineral gas, dry mineral gas, casing head gas, and residue gas remaining after the extraction of liquid hydrocarbons from wet gas, but not crude oil;

"**Natural Resources**" means any mineral, petroleum, or any other living or non-living resource that may be taken from the land or sea;

"**Non-Resident Person**" means any person who is not present in Timor-Leste for a period of, or periods in aggregate to, one hundred and eighty three days or more in the tax year in aggregate;

"**Non-Wage Benefits**" means any reward for services provided by an *employer* to an *employee*, including:

(a) the market value of any non-cash benefit provided by an *employer* to an *employee*;
(b) the value determined by the *Commissioner* of the provision by the *employer* to an *employee* of the use of a motor vehicle wholly or partly for private purposes of the *employee*;
(c) the value determined by the *Commissioner* of the provision by the *employer* of accommodation or housing;

(d) the value determined by the *Commissioner* of the provision by an *employer* to an *employee* of a housekeeper, driver, guard, gardener, or other domestic assistant; and

(e) the cost to the *employer* of providing an *employee* with any meal, refreshment, or entertainment except in the course of providing a *good* or service for the *employer* where the *Commissioner* considers that the cost of provision for the *employer* is reasonable;

"**Overall Deactivated Costs Approved**" means the total deactivation costs approved by the Designated Authority in writing, in accordance with the Deactivation or Decommissioning Plan for a petroleum project, including revisions and or amendments to date;

"**Person**" means:

(a) a natural person, including a sole trader;
(b) a company, wherever incorporated, or other juridical person;
(c) a partnership, wherever formed;
(d) a trust, wherever established; or
(e) any other unincorporated association or body of persons;

"Percentage Transfer Factor" under Sections 13 of the present Regulations and 16 of the Taxation of Bayu-Undan Contractors Act means the percentage of the right or stake held by the transferring or assigning Contractor, in a petroleum project, which is either transferred or assigned, divided by the total percentage of the right or stake held by the transferring or assigning Contractor in the petroleum project immediately before the occurrence of the transfer or assignment;

"**Petroleum**" means:

(a) any naturally occurring hydrocarbon, whether in a gaseous, liquid or solid state;
(b) any naturally occurring mixture of hydrocarbons, whether in a gaseous, liquid or solid state; or
(c) any naturally occurring mixture of one or more hydrocarbons, whether in a gaseous, liquid or solid state, as well as other substances produced in association with such hydrocarbons, and includes any petroleum as defined by paragraphs (a), (b) and (c) as defined above, that has been returned to the reservoir;

"**Petroleum Agreement**" means

(a) a contract, licence, permit, or other authorization in relation to petroleum operations made or given pursuant to the Timor-Leste Petroleum Act, except Seepage Use Authorisation; or
(b) an authorisation or production sharing contract made under the Code;

"**Petroleum Project**" means authorized activities in Bayu-Undan, with the exception of Elang Kakatua Kakatua North, under a Petroleum Agreement;

"**Reserves**" means the estimated quantity of petroleum or gas that can be expected to be profitably extracted, processed, and sold under the current and foreseeable economic conditions;

"**Reservoi**r" means an accumulation of petroleum in a geological unit limited by rock, water or other substances without pressure communication through liquid or gas to another accumulation of petroleum;

"**Resident**" in respect of a natural person means:
a natural person who is present in Timor-Leste for more than 183 days in a tax year unless the person's permanent place of abode is not in Timor-Leste;

"**Royalty**" means any amount, however described or computed, whether periodical or not, as consideration for:

(a) the use or right to use any copyright, patent, design, or model, secret formula or process, trademark, or other like property;
(b) the use or right to use any motion picture films, films or video tapes for use in connection with television or internet broadcasting, or tapes for use in connection with radio or internet broadcasting;
(c) the receipt of, or right to receive, any visual images or sounds, or both, transmitted by satellite, cable, optic fiber, or similar technology in connection with television, radio, or internet broadcasting;
(d) the supply of any scientific, technical, industrial, or commercial knowledge or information;
(e) the use of or right to use any tangible movable property;
(f) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property, supply, or right as mentioned in paragraphs (a)-(e);
(g) the partial or total forbearance in respect of any matter referred to in paragraphs (a)-(f); or
(h) the disposal of any property or right referred to in paragraphs (a)-(g);

"**Sales Tax Value**" means:

(a) for imported taxable *goods*, the *customs value* of *goods* increased by any import duty and excise tax payable on the importation of the *goods*;
(b) for taxable goods sold in Timor-Leste, the price of the *goods* not including any sales tax; and
(c) for taxable services provided in Timor-Leste, the price of the service not including any sales tax;

"**Seepage Use Authorisation**" has the meaning in the Timor-Leste Petroleum Act;

"**Services**" includes the hiring of equipment;

"**Subcontractor**" means any person supplying goods or services directly or indirectly to a Contractor in respect of a petroleum project;

"**Tax Administration**" means the National Directorate of Petroleum Revenue or any other public bodies or central services charged under the laws of Timor-Leste to carry out the enforcement of petroleum tax laws and collect petroleum taxes and duties, Commissioner or the Minister of Finance or any other competent member or organ of the Government, when exercising their administrative and or statutory power in relation to tax matters, including policies and regulations;

"T**axpayer**" is anybody, individual or corporate, who or which, pursuant to the provisions in the tax laws, is required to fulfill tax obligations (including filing of periodic information returns and registration with the Tax Administration of Timor-Leste, and who are compliant), persons required to withhold certain withholding taxes, be it income or wages-related and remit same to the Timor-Leste Tax Administration and persons who are deemed to be Contractor or Subcontractor and carrying on oil and gas business within the Annex F part of the Joint Production Development Area;

"**Tax Assessment**" means understatement of tax and or underpayment of tax including interest and any additional tax imposed under Sections 72, 73 and 74 of UNTAET Regulation 2000/18; the Law on Income Tax and the Law on the General Tax Regime and Procedures (to the extent applicable in Timor-Leste);

"**Taxable Business Activities**" means business activities carried on to derive business income and which is includible in gross income;

"Tax Collection Notice or Notice of Assessment" means a form for the imposition and collection of tax and or additional or administrative penalties either in the form of interest, fines etc.;

"Tax Correction Notice" means a notice correcting errors in writing or calculation and or errors in the application of relevant principles or provisions of tax laws in connection with a tax return or Tax Collection Notice or Notice of Assessment;

"**Tax Form**" means:

(a) an annual income tax form, including all the required information and or data;
(b) an annual Additional Petroleum Tax form, including all the required information and or data;
(c) an annual wage income tax withholding information form, including all the required information and or data;
(d) an excise tax form;
(e) the income and Additional Petroleum tax instalment forms, ;
(f) an income tax withholding form;
(g) a sales tax form;

(h) a services tax form;
(i) a wage income tax withholding form;
(j) any forms designated by the *Commissioner* for the purposes of *persons* applying for tax identification numbers and being registered for tax purposes;
(k) any forms designated by the *Commissioner* under Section 45.1(c) of the UNTAET Regulation 2000/18; or
(l) any consolidated form designated by the *Commissioner* which includes the information from 2 or more of the above forms;

provided that where, in relation to any *person*, any consolidated form has been designated by the *Commissioner*, then the forms which that consolidated form has replaced shall no longer be "tax forms";

"**Tax Period**" means a calendar month or calendar year, unless otherwise stipulated by the Commissioner and or the Minister of Finance, as the case may be;

"**Tax Return**" means a form designated as such by the Commissioner under Section 42 of UNTAET Regulation 2000/18 or described in Section 3 of the UNTAET Regulation 2000/18, including all the required information and or data or a form used by a Taxpayer to report the calculation and payment of tax due pursuant to the provisions of the applicable tax laws;

"**Tax Treaty**" means:

(a) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a sovereign country providing for the relief from double taxation and the prevention of fiscal evasion; or
(b) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a foreign country providing for reciprocal assistance in the enforcement of income tax liabilities;

"**Tax Year**" means the 12 month period from 1 January to 31 December, or if a taxpayer has permission to use a substituted tax year, the substituted tax year;

"**Timor-Leste**", when referring to a geographic area, means the territory of Timor-Leste and its territorial waters, the economic zone off the coast of Timor-Leste as defined in Section 4 of the Constitution of the Democratic Republic of Timor-Leste and recognized under the law of the Sea and by any Treaty Of Timor-Leste;

"**Timor-Leste Petroleum Act**" means the Timor-Leste Petroleum Act, 2004 as amended, varied, modified, or replaced from time to time, and includes any regulations and amendments made under the Act;

"**Timor Sea Treaty**" means the Timor Sea Treaty dated 20 May 2002 between the Government of the Democratic Republic of Timor-Leste and the Government of Australia;

"**Transaction**" means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer;

"**True taxable income**" means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto);

"**Uncontrolled comparable**" means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology.

"**Uncontrolled taxpayer**" means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests;

"**Underlying Ownership**" in relation to a legal person, means a membership interest in the person held, directly or indirectly through an interposed legal person or persons, by a natural person or by a person not ultimately owned by natural persons;

"**Wages**" means any reward for services provided by an *employer* to an *employee*, including:

(a) any salary provided to the *employee,* including leave pay, overtime payments, commissions, and bonuses;
(b) director's fees;
(c) the value of gifts provided by an *employer* to an *employee*;
(d) any allowance provided by the *employer* for the benefit of an *employee*;
(e) any payment provided by the *employer* in respect of loss or termination of employment;
(f) any payments however described made on termination of employment in respect of entitlements outstanding at the time of termination;
(g) the reimbursement or discharge by an *employer* of any expense of the *employee* including utilities expenses;
(h) the amount of any reimbursement or discharge by an *employer* of an *employee*'s medical expenses;
(i) the amount of any waiver where any *employer* waives an obligation of the *employee* to pay an amount owing to the *employer*; and
(j) *Non-wage benefits* greater than $20 provided in a calendar month to *employees* of an *employer* that is exempt from income tax;

"Verification" is a series of steps undertaken to evaluate the completeness and accuracy of an information provided to the Commissioner and or the tax administration of Timor-Leste.

Section 5

Applicable Laws

5.1

Every contractor executing a petroleum project, whether directly or indirectly through an Operator, is liable to tax in accordance with:

a) the applicable Indonesian Law on Income Tax;
b) the applicable Indonesian Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods;
c) the applicable Indonesian Law on the General Tax Regime and Procedures, as modified by the UNTAET Regulation 2000/18 and or the present Regulations, including amendments thereto and the modifications contained in the Taxation of Bayu-Udan Contractors Act, Law No. 3/2003.

5.2

The application of subparagraphs 5.1(a)-(c) above shall be done in accordance with the provisions of the UNTAET Regulation No. 1999/1.

5.3

Every Subcontractor carrying on business within the Annex F part of the Joint Production Development Area shall be subject to the provisions of Section 5.1 insofar as it is relevant and applicable to their operations as Subcontractors.

5.4

The corporate tax rate on the assessable income of a Contractor and Subcontractor shall be 30 per cent (30%).

5.5

Notwithstanding the provisions of subparagraphs 5.1 and 5.2 above, Contractors who are deemed to be taxpayers in Timor-Leste as defined in the present Regulations are exempt from the taxes of Timor-Leste, including taxes applicable under the Indonesian Law on Income Tax, the Law on Value Added Tax on Goods and services and Sales Tax on Luxury Goods, and of the Law on the General Tax Regime and Procedures, as modified by UNTAET Regulation No. 2000/18, including any amendments thereto, in relation to income and building activities, installation and operation of an export pipeline.

An amount is Timor-Leste-source income to the extent to which the amount is connected with the performance of petroleum operations or project:

(a) income from petroleum operations or project carried on by a Contractor or Subcontractor resident in Timor-Leste; or
(b) by a non-resident through a permanent establishment in Timor-Leste as determined under the present Regulation and any other applicable tax laws;

(c) income from the alienation of any movable property of a Contractor used in deriving Timor-Leste-source income referred to in subparagraphs (a) and (b);
(d) income from the lease of immovable property in Timor-Leste whether improved or not, or from any other interest in or over immovable property, including the right to explore for, or exploit, natural resources, in Timor-Leste;
(e) income from the alienation of any property or right referred to in paragraph (d) or from the alienation of any ownership interest in a legal person the assets of which consist wholly or principally of property or rights referred to in paragraph (d);
(f) dividend paid by a resident or permanent establishment;
(g) interest, royalties, management fees, annuity, or any other income paid by a resident or borne by a permanent establishment in Timor-Leste of a non-resident;
(h) income from services rendered in Timor-Leste relating to construction, building activities, construction consulting services, air or sea transportation, mining and mining consulting services, insofar as the remuneration is paid by a resident person or borne by a Timor-Leste permanent establishment of a non-resident person;
(i) notwithstanding paragraphs (a)-(h), an amount taxable in Timor-Leste under an international agreement or Treaty;

5.2.
Income is a foreign–source to the extent to which it is not Timor-Leste-source income.

Section 6
Reserve for Deactivation Costs Expenditure

6.1
Notwithstanding the provision of Article 9.1(c) of the Law on Income Tax, for the purposes of computing the taxable income for a tax year, a Contractor may deduct the annual amount transferred to a reserve established to deactivate a petroleum project against the gross income arising from the petroleum project.

6.2
The annual amount transferred to a reserve for a tax year and allowable as deduction for a tax year under Sections 4 of the Taxation of Bayu-Undan Contractors Act and 6.1 of the present Regulations, is the amount determined for that year under a Petroleum Agreement and arising from the Total Deactivation Costs agreed upon between the Designated Authority and the Contractor or Contractors.

6.2.1
The value of the reserve referred to in paragraph 6.1 for a given tax year is the value authorized in writing for that year by the Designated Authority and within the scope of the Production Sharing Contract or Contracts regulating a petroleum project, entered into between the Designated Authority and the Contractor.

6.3
As a condition precedent to the tax deductibility of Deactivation Cost allowable pursuant to Section 4 of the Taxation of Bayu-Undan Contractors Act in the current year, a Contractor is required to exhibit a copy of the approval granted by the Designated Authority to the annual tax

return submitted to the Commissioner and in which a claim is made for such deduction against the taxable income and or Additional Petroleum Tax.

6.4
The amount of Deactivation Cost deductible in a current tax year shall be calculated on the basis of the formula prescribed pursuant to Section 4(2) of the Taxation of Bayu-Undan Contractors Act.

6.5
If, at any time, the value of the Deactivation Costs deductible under this Section exceeds the amount Overall Deactivation Costs Approved, the amount of the excess shall be includible in the gross income of the Contractor in the tax year in which the excess occurs.

Section 7
Depreciation

7.1
The depreciation deductions for an asset with a useful life exceeding one (1) year allowable under Sections 5 of the Taxation of Bayu-Undan Contractors Act and 11 of the Law on Income Tax for tangible assets used in petroleum operations are permissible only when the Contractor is the legal and titled owner of the asset, and the asset is used in furtherance of the business activities of the taxpayer and exclusively in connection with a petroleum project.

7.2
The costs of acquisition, construction costs, installations, improvements or repairs that enhance the value or convert the asset from one use to the other or prolong the life of a tangible asset are required to be depreciated exclusively on a straight-line basis and each asset is required to be depreciated individually.

7.3
For the purposes of calculating depreciation deductions in respect of tangible assets used in petroleum operations and which is connected to a petroleum agreement, the amount and rates of depreciation shall be as follows:

USEFUL LIFE OF ASSETS	**DEPRECIATION RATES**
One-Four (1-4) years	Twenty five percent (25%)
Over Four (4) years	Twenty percent (20%)

7.4
Other than the year in which first production commences, the amount of the depreciation deduction allowable in that tax year under paragraph 7.3 in respect of a depreciable asset, shall be calculated in accordance with the following formula:

A x B

Where:
(**A** is the cost of the asset; and **B** is the applicable depreciation rate prescribed in paragraph 7.3).

7.5.1
In the year in which first production commences, the amount of the depreciation deduction in respect of a depreciable asset acquired, created and or constructed before the commencement of the first production is calculated in accordance with the following formula:

A x B/C
Where
A is the value determined under paragraph 7.3;

B is the number of days from the date of the first production until the end of the tax year in which the first production has occurred; and

C is the number of days in the tax year.

7.6
The depreciation of tangible assets under the present Regulation and Sections 5 of the Taxation of Bayu-Undan Contractors Act and 11 of the Law on Income Tax, whether acquired or built before the commencement of the first production, shall be calculated and be deductible for tax purposes only from the date of the first production.

Section 8
Amortisation

8.1
The amortisation of Exploration, Development and other expenses incurred in respect of petroleum activities (intangibles), including those incurred by a Contractor prior to the commencement of the first production, in creating, acquiring and or preserving an intangible asset with a useful life exceeding one (1) year, shall be calculated individually and exclusively on a straight line basis.

8.2
For the purposes of calculating amortisation deductions in respect of intangible assets used in petroleum operations and which is connected to a petroleum agreement, the amount and rates of amortisation shall be as follows:

USEFUL LIFE OF ASSETS	**AMORTISATION RATES**
One-Four (1-4) years	Twenty five percent (25%)
Over Four (4) years	Twenty percent (20%)

8.3
Other than the year in which first production commences, the amount of the amortisation deduction allowable in that tax year under paragraph 8.2 in respect of an amortisable asset, shall be calculated in accordance with the following formula:

A x B

Where:
(**A** is the cost of the asset; and **B** is the applicable depreciation rate prescribed in paragraph 8.2).

8.4.
In the year in which first production commences, the amount of the amortisation deduction in respect of an amortisable asset owned by the Contractor before the commencement of the first production is calculated in accordance with the following formula:

A x B/C
Where
A is the value determined under paragraph 8.2;

B is the number of days from the date of the first production until the end of the tax year in which the first production has occurred; and

C is the number of days in the tax year.

8.5
The amortisation of an intangible assets, whether acquired or developed before the first production date, shall be calculated and be deductible for tax purposes only from the date of the first production.

Section 9
First Production

For the purposes of Sections 7 and 8 of the present Regulation, the first production occurs when there are at least thirty (30) days of commercial production, and the commencement of the first production shall be the first 30-day period.

Section 10
Inventory

10.1
Inventories shall:

(a) conform as nearly as may be to the best accounting practice in the trade or business, and
(b) must clearly reflect the income.

10.2.
Inventories shall be valued at cost or market, whichever is lower. Where inventories are valued at cost by the Contractor, the cost shall be determined according to the absorption-cost method.

10.2.2

Where particular items of inventory are not readily identifiable, a Contractor may account for inventory under first-in-first-out (FIFO) or the weighted average cost method.

10.2.3
A change of inventory method is permissible subject to the written approval of the Commissioner and subject to any terms and conditions that the Commissioner may impose to reflect accurate income and expenditures.

10.3

(a) Use of full absorption method of inventory costing. In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income as required by section 9.1(b) of the present Regulations, both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory;
(b) the taxpayer must include as inventoriable costs all direct and indirect production costs ;
(c) costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs;
(d) costs classified as "direct production costs" are generally those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of production or manufacturing and can be identified or associated with particular units or groups of units of that product;
(e) direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units;
(f) the term "indirect production costs" includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (d) of this paragraph). Indirect production costs may be classified as to kind or type in accordance with acceptable accounting principles so as to enable convenient identification with various production or manufacturing activities or functions and to facilitate reasonable groupings of such costs for purposes of determining unit product costs.

Section 11
Withholding Tax

11.1
Pursuant to the provisions of Article 23.1(3) and Section 8 of the Taxation of Bayu-Undan Contractors Act, royalty or similar payment made by a Contractor or Subcontractor to a resident taxpayer or permanent establishment in respect of any petroleum project shall be subject to

withholding tax at five decimal four percent (5.4%), being 6% of ninety percent (90%) of the gross amount.

11.2
Pursuant to the provisions of Article 26.1(c) and (d) and Section 8 of the Taxation of Bayu-Undan Contractors Act, payments such as royalties, rent, income connected with the use of property, compensation for services, work and activities made by a Contractor or Subcontractor to a non-resident taxpayer other than a permanent establishment in Timor-Leste and in respect of any petroleum project shall be subject to withholding tax at seven decimal two (7.2%), being 8% of ninety percent (90%) of the gross amount.

11.3
Notwithstanding the provision of paragraph 10.2, compensation or remuneration paid by Contractors or Subcontractors under Article 26.1(d) of the Law on Income Tax, to dependent non-resident employees, for services connected with a petroleum shall be subject to withholding tax at eighteen percent (18%), being 20% of ninety percent (90%) of the gross amount.

11.4
The net income of a permanent establishment carrying on petroleum and natural gas exploration (drilling) activities in respect of a petroleum project shall be subject to withholding tax at five decimal four percent (5.40%), being 6% of ninety percent (90%) of the gross income, and that sum shall be the basis for the monthly tax installment payments prescribed under Section 25 of the Law on Income Tax.

11.5
The net income of a permanent establishment providing shipping or air transportation services in respect of a petroleum project shall be subject to withholding tax at two decimal sixteen (2.16%), being 2.4% of ninety percent (90%) of the gross income, and that sum shall be the basis for the monthly tax installment payments prescribed under Section 25 of the Law on Income Tax.

Section 12
Obligations of a Person Withholding Tax from a Payment

12.1
A Contractor or Subcontractor who has the obligation to withhold tax under Articles 21, 23 and 26 of the Law on Income Tax and or Section 8 of TBUCA, and who has withheld tax accordingly, shall remit the tax withheld to the Petroleum Fund account held by the Timor-Leste Central Bank within fifteen (15) days after the end of the month in which the payment was made.

12.2
At the time of the payment, the payer must issue to the recipient of the payment a withholding tax notice setting out the amount of the payment made and the amount of tax withheld from such payment.

12.3
A contractor or Subcontractor who fails to withhold tax in accordance with any enabling laws or under the present Regulations from a payment made by the person is personally liable to pay the amount of the tax which has not been withheld.

12.4
A Contractor or Subcontractor who has been personally held liable under subparagraph 12.3 above and who has made a payment of the tax due to the Timor-Leste government is entitled to recover the amount of the tax from the recipient of such payment.

12.5
For the limited purpose of the present Regulations, Section 8 of the Taxation of Bayu-Undan Contractors Act and Articles 21, 23 and 26 of the Law on Income Tax, any Contractor and or the Subcontractor obligated to withhold withholding tax shall be treated as an agent of the Tax Administration of Timor-Leste to the extent of such taxes required to be withheld.

12.5(a)
In the event of the liquidation, merger, acquisition or bankruptcy of the person holding or having control over the tax withheld, the Tax Administration and or the Government of Timor-Leste shall have a first claim of right to the tax withheld before any distribution or transfer of property is made.

12.6
The legal regime applicable in relation to the collection and recovery of tax shall apply to any amount withheld or required to be withheld in accordance with this Section.

12.7
The provisions of Sections 72 to 74 of the UNTAET Regulation 2000/18 shall be applied separately and jointly by the Tax Administration to any understatement or underpayment in respect of any tax owed and which is connected with withholding tax obligations of any person.

Section 13
Non-Deductible Expenses in respect of Income Tax

13.1
In determining the taxable income of an income taxpayer, non-deductible items shall be:

(a) distribution of profits such as dividends and by whatever name or form;
(b) penalties of any kind, penal or administrative;
(c) excessive compensation paid by a legal person for work performed and paid to shareholders or related parties as compensation;
(d) incentives, pension fund payments, and insurance premiums for personal interest and/or the families of expatriate employees, management and shareholders;
(e) losses arising from a transaction with a related party where transactions were determined by the Commissioner not to be at arm's-length;
(f) costs incurred for the benefit of a related party or shareholders;
(g) bad debts;

(h) exploration and development costs incurred before the commencement of commercial production and which are required to be capitalized;
(i) reserves, other than approved deactivation cost reserve under Section 4 of the Taxation of Bayu-Undan Contractors Act;
(j) salaries paid to members of an association, limited or unlimited partnerships without share capital;
(k) costs incurred by a Contractor and not in connection with a Contract Area as defined under the relevant Production Sharing Contract;
(l) if an income taxpayer is required to withhold tax from a payment that is deductible as necessary and ordinary business expense of the taxpayer, including payment of wages, the deduction is not allowed until the taxpayer pays the withheld tax to the Tax Administration;
(m) a fine or other monetary penalty imposed for violation of any law, rule or regulations;
(n) a bribe or any similar amount;
(o) an expenditure or loss incurred to the extent recoverable under a policy of insurance or contract of indemnity;
(p) the acquisition costs of an asset having a useful life of more than one (1) year;
(q) payments made by a permanent establishment to a head office or related party as royalties or other similar compensation in connection with property, patents or other similar rights;
(r) compensation in connection with management services between related parties;
(s) gifts, donations, aid
(t) interest payments made by a permanent establishment to a head office or related party except when connected with a debt or loan from a bank and directly connected with a petroleum project in Timor-Leste and approved by the Designated Authority;
(u) the following payments made by permanent establishment to a head office or related party:

1) long-term corporate planning;
2) policy;
3) public and government relations
4) finance\treasury;
5) advertising, donations, sponsorship;
6) entertaining;
7) legal;
8) intra-group relations; and
9) any payments whatsoever failing to meet the requirements and conditions stipulated in KEP-62

Section 14

Transfer of Rights or Stakes in a Petroleum Project

14.1

A Right or Stakes in a Petroleum Project is deemed to be transferred or assigned in whole by a Contractor where;

(a) 100% of the voting rights or value of the Contractor is transferred or sold directly or indirectly, to another person, including an entity controlled by the Contractor or controlling the Contractor,
(b) all or substantially all of the assets of the Contractor is sold or transferred to another person;
(c) statutory or de facto merger, acquisition, reorganization, amalgamation, liquidation, change of name followed by or preceded by transfer of more than 50% of the voting shares or value of the Contractor to another person.

14.2
Insofar as there is continuity of the business purpose of the transferor Contractor, the transferee Contractor shall succeed to the balance of deferred tax asset of the transferor contractor and continue to amortise any Exploration or Development Expenditure in the manner and on the same basis as the original transferor Contractor.

14.3
For the purposes of paragraph 14.2 above, there is continuity of business purpose where the transferee Contractor is engaged immediately after the transfer of a Petroleum Agreement in an actively conducted trade or business which has been so conducted under the transferred Petroleum Agreement throughout the five-year period ending on the date of the transfer by the transferor Contractor in Timor-Leste.

14.4
Where a Contractor's right or stakes in a Petroleum Operation is partially transferred or assigned to another Contractor, then:

(a) The acquiring Contractor shall be deemed to have succeeded into the gross revenues and incurred the deductible expenses equal to the percentage of the right or stakes transferred or assigned by the transferor Contractor, immediately before the occurrence of the transfer or assignment; and

(b) For the purposes of determining the accrued net revenues of the acquiring Contractor in the tax year in which the transfer or assignment occurred, the accrued net revenues of the transferor or assigning Contractor at the close of the tax year immediately preceding the year of the transfer or assignment, shall be multiplied by the "percentage transfer factor," as defined in Section 4 of the present Regulations.

Chapter II

Section 15
Annual Income Tax Return

The following persons are required to deliver a completed annual income tax form to the Tax Administration in the manner prescribed by the Commissioner:

(a) person who is required to pay income tax under the present Regulations, Taxation of Bayu-Undan Contractors Act, Law on Income Tax, the General Tax Regime and

Procedures, and UNTAET Regulation 2000/18 in connection with petroleum operation matters;

(b) any person receiving an amount that has not been correctly subject to withholding tax, where applicable under the present Regulations, Taxation of Bayu-Undan Contractors Act, Law on Income Tax, the General Tax Regime and Procedures, and UNTAET Regulation 2000/18 in connection with petroleum operation matters; and

(c) other persons or classes of persons as may be designated by the Tax Administration from time to time.

15.1
An income taxpayer required to deliver a completed income tax form for a tax year to the Tax Administration shall deliver the form not later than the last day of the third-month, following the end of the tax year to which the tax form relates.

15.2
A completed income tax return of a Contractor shall include:

(a) a completed annual income tax form designated by the Tax Administration, including any additional information and or documents required on the face of the form;
(b) profit and loss statement;
(c) book to tax reconciliation;
(d) reconciliation of the income tax return to production sharing contract return;
(e) balance sheet, including information on any change in equity section from the previous year;
(f) depreciation schedules; and
(g) description of related party transactions, including amounts and the nature of the transaction, organizational chart.

15.3
A completed income tax return of a Subcontractor shall include:

(a) a completed annual income tax form designated by the Tax Administration, including any additional information required on the face of the form;
(b) profit and loss statement;
(c) book to tax reconciliation;
(d) balance sheet, including information on any change in equity section from the previous year; and
(e) description of related party transactions (where necessary); including amounts and the nature of the transaction and organizational chart (if any).

15.4
A Contractor or Subcontractor may apply to the Tax Administration for an extension of time to deliver the annual income tax form required under this Section. The application for such an extension of time must be signed by an officer of the taxpayer and the basis of the application must be clearly stated.

15.5
An application made pursuant to subparagraph 15.4 above must be accompanied by proof of payment of the tax due in full and a calculation of the estimated tax due (if any).

15.6
The Tax Administration may, by notice in writing, grant the application for extension of time to deliver the annual income tax form upon certain terms and conditions. The granting of an extension to file the income tax return under this Section does not alter the due date for the payment of the tax due.

15.7
The income tax due from a Contractor or Subcontractor and or any other person for a tax year is due and payable not later than the last day of the third-month, following the end of the tax year.

Section 16
Contractor's Monthly Income Tax Obligations

16.1
With respect to a Contractor's first year, the Contractor shall provide an estimate of the projected tax liability to the Tax Administration not later than the 15th day of the month following the first period of thirty (30) consecutive days during which the average level of regular production delivered for sale on the twenty five (25) highest days in the thirty-day period reaches a level of regular production delivered for sale as determined by the Tax Administration.

16.1(a)
In respect of the tax years subsequent to the Contractor's first year, every Contractor shall submit to the Tax Administration an estimated income tax liability for the current tax year no later than April 15th.

16.2
The projected tax liability of a Contractor for the first tax year as determined pursuant to subparagraph 15.1 shall be divided by twelve (12) and the Contractor shall pay a monthly instalment of one-twelfth (1/12th) on the fifteenth (15th) day of each month in the first tax year.

16.3
A contractor is liable for monthly instalments of estimated income tax for each tax year. The monthly instalment is due and payable on the fifteenth (15th) day following the month to which they relate.

16.4
Excepting where the Tax Administration decides otherwise and or the Contractor's first tax year as determined under subparagraph 16.1 above, the amount of each estimated monthly tax liability of a Contractor shall be equal to one-twelfth (1/12th) of the Contractor's income tax liability for the preceding tax year. The amount of instalment due before the due date for the delivery of the Contractor's income tax return for the preceding year shall be the higher of:

(a) the amount of the instalment paid in the last month of the preceding tax year; or

(b) the average monthly tax instalment payment for the preceding tax year.

16.4(a)
If in the opinion of a Contractor the use of the prior year tax liability is unlikely to accurately predict the current year liability and lead to a material underpayment of the income tax liability for the current tax year, the Contractor may, by an application made to the Commissioner submit a different estimated tax liability.

16.4(b)
There is a material underpayment of income tax liability where the aggregate of the monthly tax payments made for a tax year is less than 90% of the actual tax liability for the tax year.

16.4(c)
Upon the approval of an application made by a Contractor under subparagraph 16.4(a) of the present Regulations by the Commissioner, the new estimated tax liability shall form the basis of the subsequent monthly tax obligations of the Contractor. Any underpayment of tax for prior periods preceding the date of the substituted estimated tax liability of a Contractor must be paid in full within five (5) business days from the date the Contractor is notified in writing of the approval of the substituted estimated tax liability by the Commissioner.

16.5
The amount of tax instalment due and payable under this Section may be determined by the Tax Administration, where:

(a) the income tax return of a Contractor for the preceding tax year is delivered after the due date, inclusive of any extension of time grated pursuant to Section 15.6 of the present Regulations;

(b) there is a material change in the Contractor's circumstances, including merger or acquisition or a natural disaster;

(c) a contractor's income tax return for the preceding year is amended, either as a result of a tax audit or self-amendment; and

(d) a Contractor fails to provide the Tax Administration with estimated income tax liability as required under Section 16.1(a) above.

16.6
An estimated tax liability previously provided to the Tax Administration may be revised by the Contractor, provided the consent of the Tax Administration is sought and obtained in advance. An estimate of tax liability delivered to the Tax Administration, including any revised version is valid for the entire tax year.

15.7

Any amounts of underpayment arising pursuant to a revised calculation of the estimated tax liability of a Contractor under subparagraph 15.6 above shall become due and payable together with the first instalment due after the revised estimate is approved by the Tax Administration. If there is an overpayment of tax arising from the revised estimate, such overpayment shall be applied as a credit against future monthly income tax liability of the Contractor.

16.8
If a Contractor's estimate made under subparagraph 16.1(a), including any revised estimate of income tax liability is less than ninety (90) percent of the Contractor's tax actual liability arising from a self-assessment and or tax audit, the Contractor shall be liable for penalty equal to:

(a) if the under-estimate is due to fraud or willful neglect, fifty (50) percent of the difference between the estimated tax liability and the actual tax liability (hereinafter called "the tax shortfall";

(b) in any other case, ten (10%) of the tax shortfall.

16.9
If the Tax Administration is satisfied that the reason for the shortfall was due to circumstances beyond the Contractor's control, such as natural disaster, material and or significant price fluctuations, and that the Contractor exercised all diligent and reasonable care in making the estimate, the tax penalties imposed pursuant to subparagraphs 15.8(a)-(b) may be waived.

Chapter III

Section 17
Additional Petroleum Tax

17.1
Pursuant to Section 11 of the Taxation of Bayu-Undan Contractors Act, a Contractor executing a petroleum project and subject to Additional Petroleum Tax in a tax year shall determine such tax liability according to the following formula:

A x 22.5%/(1-r)

Where:
A:
is the Contractor's accumulated net receipts for Petroleum Operations income for the tax year; and
r:
is the corporate tax rate (30%) as stipulated in Section 3.3 of the Taxation of Bayu-Undan Contractors Act.

17.2
The Additional Petroleum Tax imposed on a Contractor pursuant to Sections 11 of the Taxation of Bayu-Undan Contractors Act and 17 of the present Regulations on a Contractor is a separate tax from the corporate income tax imposed under Section 3.3 of the Taxation of Bayu-Undan Contractors Act Income and under the Law on Income Tax, and it is an addition to corporate income tax, where applicable.

17.3
The Additional Petroleum Tax paid by a Contractor in a tax year is an allowable deduction for the purposes of calculating the corporate income tax payable for the year in which both the corporate income tax and the Additional Petroleum Tax were paid or payable.

Section 18
Accumulated/Accrued Net Revenue

18.1
The accumulated/accrued net revenue of a Contractor in respect of a petroleum project shall be determined in accordance with the following formula; namely:

((Ax116.5%) – (1x (1-r))) + B

Where:
A:
is the Contractor's accumulated or accrued net receipts/revenue in relation to a petroleum project at the end of the previous tax year;

B :
is the Contractor's net receipts/revenue in relation to a petroleum project for the current tax year;

1:
is the interest expense and other financial charges paid by the Contractor in relation to a petroleum project in the current tax year and is entered as a negative number in the formula above; and

r
is 30% (being the corporate income tax rate specified in Section 3.3) of the Taxation of Bayu-Undan Contractors Act.

18.2
Where a Contractor is subject or liable for an Additional Petroleum Tax liability in a tax year in connection with a petroleum project as determined under the present Regulations and Section 11 of the Taxation of Bayu-Undan Contractors Act, the amount of the accumulated net receipts/revenue shall be nil for the purposes of calculating the Contractor's net revenue /receipts in the subsequent year.

18.3
In a tax year in which (**A x 116.5%**) component of the formula described in Section 17.1 above and Section 12.1 of the Taxation of Bayu-Undan Contractors Act is negative, the subtraction of (**1 x(1-r**) component of the formula shall not operate in a manner to reduce the amount of **((Ax116.5%) – (1x (1-r)))** to an amount that is less than the value of **A** component of the formula.

18.4
There shall be no carryover or carryback of any excess resulting from the application of the formula to a Contractor in any tax year.

Section 19
Contractor's Net Revenue/Receipts

19.1
For the purposes of the Additional Petroleum Tax, the net revenue/receipts of a Contractor in respect of petroleum project for a tax year is gross revenue/receipts of all includible income of the Contractor for the tax year less the total allowable deductible expenditures of the Contractor in respect of petroleum project for the year.

19.2
The net revenue/receipts of a Contractor arising from a petroleum project may be a negative sum in any tax year.

Section 20
Gross Revenue/Receipts

20.1
For the limited purposes of gross revenue/receipts in relation to the computation of the Additional Petroleum Tax of a Contractor in a given tax year, the gross receipts of a Contractor arising from petroleum project, is the aggregate of the following amounts:

(a) all income items under the Taxation of Bayu-Undan Contractors Act, Articles 4 and 5 of the Law on Income Tax or any other applicable laws and or Treaty, earned or accrued in the year in connection with or from petroleum project but excluding interest income, earned or accrued during the tax year;
(b) any consideration received by the Contractor in the year and in respect of the disposal, transfer, alienation or destruction, or loss of property, including materials, equipment, plant facilities, intellectual property or rights used in connection with petroleum project, if the expenditure incurred in acquiring the property has been in deducted in computing the net revenue/receipts of the Contactor for any tax year;
(c) any amount received by the Contractor in the tax year in respect of the provision of information and or data obtained from any survey, evaluation, appraisal, or study in connection with petroleum project where the related expenditure incurred in undertaking the survey, appraisal, or study has been deducted in computing the net revenue/receipts of the Contractor for any tax year;

(d) any amounts received by the Contractor in the tax year that is a reimbursement, refund or other compensation, for an amount previously deducted, cash or otherwise, in computing the net revenue/ receipts of the Contractor for any tax year; and
(e) any compensation, indemnity and or damages received from an insurance policy or similar instruments, indemnity agreement, settlement or judicial decision, by a Contractor in respect of any property used in petroleum project where such property was destroyed and or damaged.

20.2
An amount received or accrued as consideration for the transfer of an interest, right and or stakes in petroleum project is excluded from the computation of the gross revenue/receipts of a Contractor under paragraph 19.1 of the present Regulations and Section 14.1 of the Taxation of Bayu-Undan Contractors Act.

20.3
For the purpose of calculating the net revenue/receipts of a Contractor in a tax year, the amounts includible as part of the gross receipts of a Contractor under subparagraph 19.1 is limited to the portion of such amounts attributable to the petroleum project of the Contractor.

Section 21
Deductible Expenses in respect of Additional Petroleum Tax

For the limited purposes of calculating the Additional Petroleum Tax imposed under Section 11 of the Taxation of Bayu-Undan Contractors Act (including any amendments thereof), a Contractor may deduct the following items in a tax year:

(a) permissible deductible expenditures incurred by the Contractor in a tax year in respect of the petroleum project, excluding the amounts allocable to depreciation and or amortisation deductions;
(b) interest and other financing charges in connection with the petroleum project in a Contract Area as approved by the Designated Authority;
(c) capital expenditure incurred in a tax year in respect of acquisition or construction of a tangible or intangible asset for use in the petroleum project in which the Contractor is engaged in a Contract Area, excluding an amount paid as consideration by a Contractor for the acquisition of an interest, right and or stake in a petroleum project;
(d) operating expenditure incurred by the Contractor in the current year in respect of the petroleum operation in which the Contractor is engaged in a Contract Area; and
(e) an amount of Timor-Leste corporate income tax calculated by applying the rate specified in Section 3.3 of the Taxation of Bayu-Undan Contractors Act to the taxable income of the Contractor, excluding any additional taxes or interest imposed under Sections 72-74 of the UNTAET Regulation 2000/18, or under the present Regulations.

21.1
The amounts deductible under subparagraphs (a)-(e) are limited to those directly attributable to the petroleum project of the Contractor and in respect of a specific Contract Area.

21.2
If any part of the amount of deductible expenses incurred by a Contractor and deductible under this Section is attributable to any other activity other than a petroleum project, only the portion of the deductible expenses relating specifically to the petroleum project shall be treated as a deductible expense in the computation of the net revenue in respect of the petroleum project.

Section 22

Exclusion of the Consideration paid or imputed in connection with the acquisition of an Interest or Stake in a Petroleum Project

22.1
Any consideration, including all transactions costs paid or accrued by a Contractor in respect of the acquisition of an interest, right and or stake in a petroleum project under Section 16 of the Taxation of Bayu-Undan Contractors Act shall be excluded from the permissible deductible expenditure under Section 21 of the present Regulations and Section 15 of the Taxation of Bayu-Undan Contractors Act.

Section 23

Annual Additional Petroleum Tax Return

23.1
Every Contractor having an Additional Petroleum Tax obligation under Sections 16 of the present Regulations and 11 of the Taxation of Bayu-Undan Contractors Act shall deliver a completed annual Additional Petroleum Tax return form to the Tax Administration in the manner prescribed by the Commissioner.

23.2
Any Contractor required to deliver a completed annual Additional Petroleum Tax return form to the Tax Administration shall deliver the form and any outstanding Additional Petroleum Tax liability not later than the last day of the third-month, following the end of the tax year to which the tax form and the tax liability relate.

23.3
A completed annual Additional Petroleum Tax return of a Contractor means a completed annual Additional Petroleum Tax return form designated by the Tax Administration, including any additional information and or documents required on the face of the form, or by the Tax Administration.

23.4
On or before the due date, a Contractor may apply to the Tax Administration for an extension of time to deliver the annual Additional Petroleum Tax return form required under this Section. The application for such an extension of time must be signed by an officer of the taxpayer and the basis of the application must be clearly stated on the face of the application.

23.5
An application made pursuant to subparagraph 23.4 above must be accompanied by proof of the payment of the tax due in full and a calculation of the estimated tax due.

23.6
The Tax Administration may, by notice in writing, grant the application for extension of time to deliver the annual Additional Petroleum Tax return form upon certain terms and conditions. The granting of an extension to file the Additional Petroleum Tax return under this Section does not alter the due date for the payment of the tax due.

23.7
The Additional Petroleum Tax return due from a Contractor for a tax year is due and payable not later than the last day of the third-month, following the end of the tax year to which the tax relates.

23.8
Notwithstanding the provision of paragraph 23.4 above, a Contractor may apply to the Tax Administration for the extension of the time within which to file the annual Additional Petroleum Tax return after the expiration of the due date stipulated in subparagraph 23.1, provided that the Contractor making such application is able to show exceptional circumstances warranting the grant of such application.

23.8(a)
The Tax Administration may grant an application made under paragraph 23.8 above upon certain terms and conditions, including the payment of any outstanding tax liability of the Contractor making such application and or the payment of any prescribed fees.

Section 24
Contractor's Monthly Additional Petroleum Tax Obligations

24.1
Every Contractor having an Additional Petroleum Tax obligation under Section 17 of the present Regulations and Section 11 of the Taxation of Bayu-Undan Contractors Act shall be liable for monthly instalments of Additional Petroleum Tax.

24.2
Every Contractor having an Additional Petroleum Tax obligation under Section 17 of the present Regulations and Section 11 of the Taxation of Bayu-Undan Contractors Act shall deliver to the Tax Administration an estimate of Additional Petroleum Tax due for a tax year not later than the due date for payment of the first Additional Petroleum Tax instalment due for that tax year.

24.3
The estimated Additional Petroleum Tax liability of a Contractor for a tax year as determined pursuant to subparagraph 24. 2 shall be divided by twelve (12) and the Contractor shall pay a monthly instalment equal to one-twelfth ($1/12^{th}$) on the fifteenth (15th) day of each month following the month in which they relate.

24.4
Where the first obligation of a Contractor under Sections 16 of the present Regulations and 18 of the Taxation of Bayu-Undan Contractors Act commences in a month other than the month of January, the monthly instalments due and payable by the Contractor under subparagraph 23.3 above shall be calculated by dividing the remaining month(s) of that tax year by the estimated Additional Petroleum Tax determined under subparagraph 24.2 of the present Regulations.

24.5
Excepting where the Tax Administration decides otherwise and or the Contractor's first Additional Petroleum Tax obligation commenced in a month other than the month of January in a tax year, the amount of each estimated monthly Additional Petroleum Tax liability of a Contractor shall be equal to one-twelfth ($1/12^{th}$) of the Contractor's Additional Petroleum Tax liability for the preceding tax year. The amount of instalment due before the due date for the delivery of the Contractor's monthly Additional Petroleum Tax return for the preceding year shall be the higher of:

(c) the amount of the instalment paid in for the last month of the preceding tax year; or

(d) the average monthly tax instalment payment for the preceding tax year.

24.6
The amount of tax instalment due and payable under this Section and Section 18 of the Taxation of Bayu-Undan Contractors Act may be determined by the Tax Administration, where:

(a) the annual Additional Petroleum Tax return of a Contractor for the preceding tax year is delivered after the due date, inclusive of any extension of time grated pursuant to Section 22 of the present Regulations;

(b) there is a material change in the Contractor's circumstances, including merger or acquisition or a natural disaster;

(c) a contractor's Additional Petroleum Tax return for the preceding year is amended, either as a result of a tax audit and or self-amendment; and

(d) a Contractor fails to provide the Tax Administration with estimated Additional Petroleum Tax liability as required under Section 24.2 above and under Section 18 of the Taxation of Bayu-Undan Contractors Act.

24.6.1
An estimate of tax liability made by the Tax Administration under Section 24.6 above, including any revised version is valid for the entire tax year.

24.7
An estimated Additional Petroleum Tax liability previously provided to the Tax Administration or an estimate made by the Tax Administration under Section 24.6 above may be revised by the Contractor, provided the consent of the Tax Administration is sought and obtained in advance.

An estimate of tax liability delivered to the Tax Administration, including any revised version is valid for the entire tax year.

24.8.
Any amounts of underpayment arising pursuant to a revised calculation of the estimated tax liability of a Contractor under subparagraph 24.7 above shall become due and payable together with the first instalment due after the revised estimate is approved by the Tax Administration. If there is an overpayment of tax arising from the revised estimate, such overpayment shall be applied as a credit against future monthly Additional Petroleum tax liability of the Contractor.

24.9
If in a tax year, a Contractor's estimate made under this Section and Section 18 of the Taxation of Bayu-Undan Contractors Act in respect of the Additional Petroleum Tax obligation of a Contractor, including any revised estimate, is less than ninety (90) percent of the Contractor's actual tax liability arising from a self-assessment and or tax audit, the Contractor shall be liable for penalty equal to:

(a) if the under-estimate is due to fraud, scheme and or willful neglect, fifty (50) percent of the difference between the estimated tax liability and the actual tax liability (hereinafter called the "APT" shortfall"; or

(b) in any other case, ten (10%) of the APT shortfall.

24.10
If the Tax Administration is satisfied that the reason for the APT shortfall was due to circumstances beyond the Contractor's control, such as natural disaster, material and or significant price fluctuations, and that the Contractor exercised all diligent and reasonable care in making the estimate, the tax penalties imposed pursuant to subparagraphs 24.9(a)-(b) may be waived by the Tax Administration.

Chapter IV

Section 25

Allocation and Reallocation of Income and Expenditures among Related Parties and or Associates/Anti-avoidance Rules & Policies

The primary purpose of Section 25 of the present Regulation is to amplify the provisions of Sections 91-93 of the UNTAET Regulation 2000/18 and Article 18 of the Law on Income Tax to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. The referenced Sections above are intended to put a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This Section sets forth general principles and guidelines to be followed in the determination of the true taxable income and expenditures in transactions involving associates or related parties.

25.1
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the Timor-Leste, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner may distribute, apportion, reapportion, or allocate or reallocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes and or to clearly reflect the true taxable income of any of such organizations, trades, or businesses.
The Commissioner may make such a determination where terms and or conditions are made or imposed between the associated enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises.

25.2
In the case of any transfer or license of intangible property between a Contractor and a party owned or controlled directly or indirectly by the same interest, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible property.

25.3
The Commissioner may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the Commissioner may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

25.4
Generally, in the process of the determination of the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same or identical circumstances (arm's length result).

25.5
The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

25.6
An arm's length result may be determined under any method without requesting a taxpayer to establish the inapplicability of another method, but if another method is subsequently shown to produce a more reliable measure of an arm's length result; such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances,

provides the most reliable measure of an arm's length result.

25.7
Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule. Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis performed under another method.

Best method rule:
The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result; such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

25.8
In general, whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under similar circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors).

25.9
Comparability factors include:

(a) **Functions**
Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions

include— (A) Research and development; (B) Product design and engineering; (C) Manufacturing, production and process engineering; Product fabrication, extraction, and assembly; (E) Purchasing and materials management; (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities; (G) Transportation and warehousing; and (H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(b) **Material contractual terms and conditions**

Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include— (1) The form of consideration charged or paid; (2) Sales or purchase volume; (3) The scope and terms of warranties provided; (4) Rights to updates, revisions or modifications; (5) The duration of relevant license, contract or other agreements, and termination or renegotiation rights; (6) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and (7) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required.

1. Written agreement. The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. If the contractual terms are inconsistent with the economic substance of the underlying transaction, the Commissioner may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

2. No written agreement. In the absence of a written agreement, the Commissioner may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights. For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the Commissioner may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods.

(c) **Risks**

1. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include— (1) Market risks, including fluctuations in cost, demand, pricing, and inventory levels; (2) Risks associated with the success or failure of research and development activities; (3) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates; (4) Credit and collection risks; (5) Product liability risks; and (6) General business risks related to the ownership of property, plant, and equipment.

2. Identification of taxpayer that bears risk. In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the material provisions of the contractual terms as indicated in Section 20.8(b) above. Consequently, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable may indicate the lack of economic substance. In considering the economic substance of the transaction, the following facts are relevant;

(a) whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

(b) whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(c) the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(d) **Economic condition**

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include— (a) the similarity of geographic markets; (b) the relative size of each market, and the extent of the overall economic development in each market; (c) the level of the market (e.g., wholesale, retail, etc.); (d) the relevant market shares for the products, properties, or services transferred or provided; (e) the location-specific costs of the factors of production and distribution; (f) the extent of competition in each market with regard to the property or services under review; (g) the economic condition of the particular industry, including whether the market is in contraction or expansion; and (h) the alternatives realistically available to the buyer and seller.

(e) **Nature of property or services involved in the transaction**

Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangible property that is embedded in tangible property or services being transferred. The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied.

25.10
Standard of comparability.

In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

25.11
A material difference is one that would materially affect the measure of an arm's length result under the method being applied. Where practicable, adjustments must be made by the taxpayer to cure the effect of such material differences on prices or profits if such effects can be ascertained with reasonable accuracy to improve the reliability of the results.
If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced.

25.12
Arm's length range:

(a) Generally, the application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(b) Determination of arm's length range

1. **Single method**. The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. Use of more than one method may be appropriate for the purposes of determining the best method.

2. **Selection of comparables**. Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable

measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

3. **Comparables included in arm's length range**. Generally, the arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

4. **Adjustment of range to increase reliability**. If there are no uncontrolled comparables described in this Section, the arm's length range selected from the results of all the uncontrolled comparables, should achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

5. **Interquartile range**. For purposes of this section, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

6. **Adjustment if taxpayer's results are outside arm's length range**. If the results of a controlled transaction fall outside the arm's length range, the Commissioner may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to the median of all the

results. The median is the 50th percentile of the results, which is determined in a manner analogous to that described in paragraph 20.11(b)(5) of this Section (Interquartile range). In other cases, an adjustment normally will be made to the arithmetic mean of all the results.

7. **Arm's length range not prerequisite to allocation**. The rules of this Section and Sections 91-93 of the UNTAET Regulations 2008/18 do not require that the Commissioner establish an arm's length range prior to making an allocation and or reallocation between related parties.. Thus, for example, the Commissioner may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices, then then no allocation will be made.

8. **Scope of review:**
The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer.
   i. Intent to evade or avoid tax not a prerequisite: In making allocations under this Section or the relevant parts of UNTAET Regulation 2000/18, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

   ii. Realization of income not a prerequisite: The Commissioner may make an allocation under Sections 91 and or 93 of the UNTAET Regulation 2000/18 even if the income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the Commissioner may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year. Similarly, if a controlled taxpayer lends money to a related taxpayer in a taxable year, the Commissioner may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under this Section or under the UNTAET Regulations 2008/18 is not precluded.

iii. Non-recognition provisions may not bar allocation: If necessary to prevent the avoidance of taxes or to clearly reflect income, the Commissioner may make an allocation under this Section and or under the UNTAET Regulations with respect to transactions that otherwise qualify for non-recognition of gain or loss under applicable provisions of Timor-Leste tax laws.

25.13

Rules relating to determination of true taxable income.

The following rules must be taken into account in determining the true taxable income of a controlled taxpayer:

1) **Aggregation of transactions**: The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services.

2) **Allocation based on taxpayer's actual transactions**: The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the Commissioner may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer.

3) **Multiple year data**: The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be appropriate, however, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years may be used.

4) **Allocations apply to results, not methods**: In evaluating whether the result of a controlled transaction is arm's length, it is not necessary for the Commissioner to determine whether the method or procedure that a controlled taxpayer employs to set the terms for its controlled transactions corresponds to the method or

procedure that might have been used by a taxpayer dealing at arm's length with an uncontrolled taxpayer. Rather, the Commissioner will evaluate the result achieved rather than the method the taxpayer used to determine its prices.

5) **Collateral adjustments with respect to allocations under this Section and or Sections 91-93 of the UNTAET Regulations**. In general, the Commissioner will take into account appropriate collateral adjustments with respect to allocations made with respect to related party transactions.. Appropriate collateral adjustments may include correlative allocations, tax credit, conforming adjustments, and setoffs.

Section 26

Transfer Pricing Methods in Connection with the Transfer of Tangible and Intangible Properties

26.1(a)

In general. The arm's length amount charged in a controlled transfer of property must be determined under one of the six methods listed in this paragraph. Each of the methods must be applied in accordance with all of the provisions of Section 23 of the present Regulations, including the best method rule, the comparability analysis of and the arm's length range as described in Section 25 above.

26.1(b)

The transfer pricing methods in connection with the transfer of tangible property are:

(a) the comparable uncontrolled price method;
(b) the resale price method;
(c) the cost plus method;
(d) comparable profit method;
(e) profit split method; and
(f) Unspecified methods.

26.1(c)

Comparable Uncontrolled Price Method ("CUP")

The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction. Provided that the comparability requirement is satisfied, the results derived from applying the CUP method generally be will be the most direct and reliable measure of an arm's length price.

The CUP may be ascertained based on comparable purchases and sales either between the taxpayer and unrelated parties or sales between two unrelated parties. While no two sales are the same, the Tax Administration is of the view that sufficient comparability exists if similar products are sold under the circumstances that are substantially the same, and any differences in the products or circumstances either have no effect on prices or have differences that can be measured and eliminated with a reasonable number of adjustments as indicated in Section 23 above.

A proposed CUP methodology may be adjusted for many factors, including:

(a) quality of the product;
(b) contractual terms like warranty, credit terms, sales volume, or delivery terms;
(c) level of the market-wholesale or resale;
(d) geographic market;
(e) date of the transaction
(f) intangible property associated with the sale;
(g) foreign currency risks; and
(h) purchaser or buyer alternatives.

The CUP method is also allowed where data from public exchanges or quotation media is available for the property. This type of data is useful typically to price intercompany transactions involving commodities products like oil, gas, minerals etc. The following requirements must be met in order to use such data, namely:

1. the data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;
2. the data is used to set prices in the controlled transaction in the same way that it is used by uncontrolled taxpayers in the industry; and
3. the amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by the uncontrolled taxpayers.

Taxpayers should note however, that if there are material products differences for which reliable adjustments cannot be made, the CUP method will not satisfy the best method rule as described in Section 25 above.

26.1(d)

Resale Price Method (RPM)

The resale price method (RPM) is an arm's length evaluation of price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (resale price) is then reduced by an approximate gross margin on this price ("resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and in the light of the functions performed (taking into consideration assets used and quantum of risk assumed), make an appropriate profit. Essentially, the price is determined under the RPM by subtracting the "appropriate gross profit" from the "applicable resale price" of the item involved.

What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm's length price for the original transfer of property between associated enterprises.

The RPM establishes an arm's length price for the sale between a supplier and a related reseller by applying the gross margin achieved in a comparable transaction, but not necessarily involving

exactly similar products, to the resale price of the affiliated reseller. Also, the RPM earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide.
Based on the principles established in Section 20 above, an uncontrolled transaction is comparable to a controlled transaction for purposes of the RPM if one or two conditions are met, namely:

1) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or
2) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Other specific factors that may be appropriate for consideration when a taxpayer elects to use the RPM are:

1) contractual terms;
2) functions performed
3) inventory and turnover rates;
4) corresponding risks;
5) sales, marketing, advertising programs; and
6) market level-wholesale or retail.

In cases where the RPM used is that of an unrelated independent enterprise in a comparable transaction, the reliability of the RPM may be affected if there are material differences in the ways the associated enterprises and the unrelated enterprises execute their businesses. Such differences may impact the costs taken into consideration, and consequently affect the profitability level of an enterprise but may not necessarily affect the price at which it buys and sells its goods or services in the market place.
Peculiar circumstances like those mentioned in this paragraph should be analyzed in determining whether an uncontrolled transaction is comparable for purposes of applying the RPM.

26.1(e)
Cost-Plus Method
Generally, the cost-plus method determines an arm's length charge by examining the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services rendered to an associated purchaser. An appropriate markup is then added to this cost. The cost plus the added markup may be regarded as an arm' length price of the original controlled transaction. The cost plus markup of the supplier in the controlled transaction should ideally be established by reference to the cost plus markup that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus markup that would have been earned in comparable transactions by an independent enterprise may serve as a guide

The cost plus method is used mainly in manufacturing, assembly, or other production of goods that are sold to associated enterprises. In determining the arm's length benchmark, adjustments should be made for material differences between uncontrolled and controlled transactions where it can be determined that such differences have definite and reasonably ascertainable effect on the margins. The extent and reliability of such adjustments will affect the relative reliability of the analysis under the cost plus method in certain cases.

Taxpayers using the cost plus method to establish arm's length price should pay particular attention in applying a comparable markup to a comparable cost basis. The cost plus method relies mostly upon a comparison of the markup on costs achieved in a controlled transaction and the markup on costs achieved in or more comparable uncontrolled transactions. In the circumstances, differences between the controlled and uncontrolled transactions that have effect on the size of the markup must be analyzed to determine what adjustments should be made to the uncontrolled transactions respective markup.

Taxpayers using the cost plus method must consider the following factors:

1. complexity of manufacturing or assembly;
2. procurement, purchasing, and inventory-control activities;
3. testing functions;
4. operating and non-operating expenses; and
5. contractual terms.

26.1(f)

Comparable Profit Method (CPM)

The determination of the arm's length price under the comparable profit method is predicated upon objective measures of profitability level indicators ("PLIs") that are derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The method is acceptable so long as it is consistent with the Best Method and comparability rules discussed above.

Under the CPM, the arm's length is determined by calculating what a taxpayer's operating profit would have been on related party transaction if its profitability levels were equal to that of an uncontrolled comparable and then comparing that result with to the interquartile range calculated based on the results of the comparable enterprises. In calculating the taxpayer's operating profits, the selected PLIs should be applied solely to the taxpayer's financial data that is related to the controlled transactions.

Since the CPM is a profit based method, taxpayers are required to select which of the related parties that engaged in the controlled transactions will be the party whose profits will be tested for meeting the requirements of the arm's length standard. The tested party should be the related party whose operating profit margin attributable to the controlled transactions can be verified using the most accurate data and requiring the least adjustments, and for which reliable comparable data can be located.

In selecting a pool of comparables from which the PLI will be determined, the standards of comparability will allow for diversity of products and functions. Relevant comparability factors may include the size and scope of operations, lines of business, product and markets and balance sheet items. As a result of the peculiarity of this CPM, taxpayers should broaden the functional analysis to cover more dimensions of those business factors that affect profitability.

Taxpayer's choice of a particular PLI out of other PLIs should be based on the nature of activities under review, and on supporting data availability.

Once a particular PLI has been selected by the taxpayer, the arm's length range should be determined by calculating the interquartile range from the company operating profits. The

interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables.

26.1(g)

Comparable Profit Split Method

The profit split method compares the allocation of the combined operating profit or loss attributable to controlled transactions to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The profit or loss is then split amongst the associated enterprises on an economically valid basis that approximates the division of profits or loss that would have been anticipated and reflected in an agreement made at arm's length.

The comparative profit method generally divides the total operating income of the buyer and seller in the controlled transaction in a manner that is consistent with the way comparable unrelated parties divide their operating income in similar transactions.

The data on comparable transactions and the resulting profits splits between unrelated parties must be employed, if available. The data must address two independent parties, each having risks, functions, and intangibles substantially comparable to those of the uncontrolled parties. Locating comparable enterprises engaged in transactions that are similar to those of those the buyer and the seller and data distinguishing how the independent parties shared the combined profits from a comparable transaction is extremely difficult.

26.1(h)

Residual Profit Split Method

The residual profit method operates in a two-step process. The first step assigns an arm's length return to the conventional activities of the buyer and the seller in controlled transactions. This allocation is done by first granting the buyer and the seller an arm's length returns for functions performed that are contributory to the profits. These functions include, manufacturing, advertising and marketing, distribution and the exploitation of intangibles (if any).

The second step involves the allocation of the residual profit between the buyer and the seller based on the corresponding value of their contributions of intangible property to the business activity. Taxpayers are allowed to allocate the residual profits between the buyer and the seller insofar as a discernible benchmark can be established as a basis of the allocation formula. Factors that a taxpayer may include in setting the allocation benchmark may include the capitalized cost of developing the intangibles, enhancements etc.

26.1(i)

Unspecified (other) Methods

Other the arm's length standards mentioned specifically in Section 25 of the present Regulations, taxpayers may use other methods to determine the transfer price prices charged for the exchange of goods or services between related enterprises. As with the other specified methods, taxpayers will be required to demonstrate that the unspecified method selected is consistent with the Best and comparability rules as described in Section 20 above.

Section 27

Transfer Pricing Enforcement and Penalties

27(a)

Civil penalties

The provisions of Sections 73 and 74 of the UNTAET Regulations 2000/18 (including amendments) shall apply *in pari materia* for:

1. transfer pricing *underpayment* of tax arising from any transfer pricing adjustment made by the Tax Administration under the present Regulations or any other applicable laws; and
2. transfer pricing *understament* of tax arising from any transfer pricing adjustment made by the Tax Administration under the present Regulations or any other applicable laws.

27(b)

The provisions of Sections 27(a) and 2(b) above are applicable concurrently and independently of each other.

27(c)

The civil penalties prescribed under this Section is applicable where the "net adjustment for a taxable year" exceeds a ten (10) per cent threshold of the gross receipts. In a case in which the "net adjustment for a taxable year" results in a ten (10) per cent or more, the inaccuracy is hereby designated as "substantial valuation misstatement."

27(d)

The "net adjustment for a taxable year" is with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments made under this Regulations and Section 91-93 of the UNTAET Regulations 2000/18 in the price for any property or services (or for the use of property). In determining the net increase in taxable income, increases resulting from collateral adjustments under the present Regulations are disregarded.

27(e)

The relevant adjustments are limited to adjustments to the amounts reported by a taxpayer on an income tax return (the original return or an amended return filed before the Tax Administration has contacted the taxpayer regarding the corresponding original return), notwithstanding whether the amount reported differs from the transaction price initially reflected on the taxpayer's books and records.

27(f)

Burden of proof

In any related party transaction, the taxpayer shall be responsible for establishing that the transaction is consistent with the arm's length standards as provided in Sections 25 and 26 of the present Regulations and Sections 91 and 93 of the UNTAET Regulation 2000/18.

Section 28
Documentation Requirements

28(a)

A taxpayer with an aggregate related party transaction or transactions in the sum of Five Hundred Thousand US Dollars (US$500,000) or more in a tax year is required to report and disclose such transaction(s) in the income tax return filed for the year in which the transaction(s) occurred. Taxpayers are also required to keep and maintain accessible books and records containing all relevant information about such transaction(s) for a period of seven (7) years, commencing from the date the information or tax return containing the disclosures is filed with the Tax Administration.
In addition, such taxpayers are required to compile transfer pricing documentation supporting the pricing of the related party transaction(s) in the sum of US$500,000 or more.

28(b)
The transfer pricing documentation requirement of subparagraph 28(a) is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the Best Method Rule as described in Section 25 of the present Regulations and provides that documentation to the Tax Administration within thirty (30) days of a request for it in connection with an examination of the taxable year to which the documentation relates.
The documentation must be in existence when the return is filed. The Commissioner may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known.

28(c)
The principal documents to be maintained by a taxpayer with related party transaction(s) falling within the threshold stipulated in subparagraph 28(a) above includes:

i. an overview of taxpayer's business, including an analysis of the economic and legal factors affecting pricing;
ii. a description of taxpayer's organizational structure covering all related parties engaged in transactions potentially relevant under Section 25 of the present Regulations and Sections 91-93 of the UNTAET Regulation 2000/18;
iii. a description of the method selected and an explanation why the method was selected;
iv. a narrative of the alternative methods that were considered and the reasons for rejecting those alternatives methods;
v. a description of controlled transactions and any internal data used to analyze those transactions;
vi. a description of the comparables that were used, how comparability was evaluated, and what adjustments (if any) were made;
vii. an explanation of the economic/functional analysis and projections relied upon in developing the method;
viii. a description or summary of any relevant data that the taxpayer obtains after the end of the year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and
ix. a general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

28(d)

Other tan items viii and ix under subparagraph 28(c) above, the documentation must have been in existence at the time the return was filed.

28(e)
A taxpayer with a Section 25 reporting obligation is required to use the most current reliable data available before the end of the taxable year in question and the documents are required to generally reflect the data.

28(f)
A transfer pricing documentation developed for a foreign tax jurisdiction is not sufficient for purposes of Sections 25 and 29 of the present Regulations.

Section 29
UNTAET Regulation 2000/18

Other administrative matters not expressly covered under the present Regulations, including but not limited to tax appeals shall continue to be governed by the UNTAET Regulations 2000/18 (including amendments thereto) and the Law on the General Tax Regime and Procedures, with the modifications contained in the present Regulations

Chapter V

Section 30
Tax Audit

(a) the Tax Administration shall conduct periodic tax audits to test tax compliance and for other lawful purposes in the context of implementing and enforcing relevant provisions of tax laws;

(b) a tax audit is commenced with an official tax audit notification issued by the Tax Administration and delivered to a taxpayer, or the taxpayer's representatives, as the case may be;

(c) a taxpayer under tax audit shall, upon a written request by the Tax Administration;

i. show and or submit books and records, or copies thereof, documents and or information specifically requested by the Tax Administration and forming the basis of the book and records, documents pertaining to income received, expenditures incurred, business activities, independent work of the taxpayer or the

independent work performed for the taxpayer and connected with a petroleum project, directly or indirectly;

ii. grant access to enter such places or offices, factory, installations, platforms, Contract Area as is deemed necessary and material to carrying out the audit.

(d) tax audits shall be undertaken on the basis of an annual plan, adopted by the Tax Administration, based on the tax risk profile and the significance of the taxpayer. When adopting the plan, the evaluation of the effect of tax audit and control on the efficiency of tax collection in relation to Petroleum Operations in future periods shall also be taken into consideration.

Section 31
Tax Audit Methods

Tax audit methods shall include:

(a) desk or office controls;
(b) field controls; and
(c) referrals to the Prosecutor General's office or any other appropriate governmental agency with a view of determining the commission of a tax-related offense.

Section 32
Office Control

Office control is a set of actions by means of which the Tax Administration verifies the accuracy, completeness, truthfulness and legal base of the data shown in tax or information returns of whatever description, as well as the tax balances, accounting statements and other statements or positions of the taxpayer, comparing the said data to data from tax accounting records and other official records kept by, or at the disposal of, the Tax Administration.

Office controls shall be undertaken in the premises of the Tax Administration by tax auditors or inspectors and or lawyers.

Section 33
Processing of Tax Returns and other Statements of the Taxpayer

During the procedure of office controls of receipt and processing of a tax return:

(a) the verification of the mathematical accuracy, formal accuracy and completeness or truthfulness of the tax return and other statements filed by the taxpayer shall be

performed by the Tax Administration in accordance with all the applicable Laws and internal guidelines and procedures;

(b) if during the processing of tax return and other statements a mathematical error is detected, the Tax Administration shall correct such error and notify the taxpayer immediately to pay any difference or determine the amount of tax refund;

(c) if during the processing of the tax return and other statements it is determined that they are formally incorrect, incorrectly filled out or incomplete, the tax auditor or inspector shall by a written notification instruct the taxpayer to remove any error or complete the tax return and other statements within fourteen (14) days; and

(d) if the taxpayer does not proceed in accordance with the written instruction as indicated in subparagraph c above, it shall be considered that the tax return or other statements, as the case may be, were not filed with the Tax Administration.

Section 34
Participation of a Taxpayer in Office Control Procedure

(a) The taxpayer under tax audit shall be under the obligation to participate, directly or through a tax representative, in furtherance of the desk or office control tax audit, at a request from the Tax Administration, and to give the requested explanations, documentations or information within the term specified by the Tax Administration; and

(b) The failure of the taxpayer to respond is not a bar to further the desk or office tax audit in any manner determined by the Tax Administration until the process is completed in accordance with the applicable tax laws.

Section 35
Change of Tax Liability upon Findings of Desk/Office Controls

(a) if there is a change of the amount of tax liability during the procedure of desk or office control, the tax auditor or inspector shall prepare a report of the summary of the facts and the findings in triplicates;

(b) a copy of the summary report provided under subparagraph (a) shall be sent to the taxpayer within ten (10) business days from the date of the report;

(c) the taxpayer shall have a right to file an objection against the report within five (5) business days after the receipt of the report. The objection must clearly state the ground(s) and the relief(s) sought from the Tax Administration;

(d) the tax Administration is required to review the objection and make a determination within thirty (30) days from the date of the receipt of the objection;

(e) if the objection filed by the taxpayer pursuant to subparagraph (c) above is granted, the Tax Administration shall issue a "No further action required" letter to the taxpayer within forty-five (45) days; and

(f) if the objection filed by the taxpayer pursuant to subparagraph (c) above is dismissed, the Tax Administration shall issue a tax assessment accordingly, and the procedure set out in Section 69 of UNTAET Regulation 2000/18 in respect of tax appeals shall apply thereafter.

Section 36
Field Audit Controls

(a) field audits shall be undertaken within the premises of the taxpayer in Timor-Leste and or the offices of the Tax Administration or another location in Timor-Leste as may be determined by the Commissioner;

(b) field control shall be undertaken by a team constituted for that purpose by the Tax Administration;

(c) field control shall be undertaken on the basis of a control order or notice issued by the Tax Administration to the taxpayer;

(d) the Tax Administration may postpone the commencement of field control if the taxpayer submits a written complaint immediately upon the receipt of the control order indicated in subparagraph 34(c) above, and state the factual and the legal reasoning showing that the control or notice is contrary to Law. Such a complaint must be delivered to the Tax Administration within three (3) business day from the date of the receipt of the control order or notice stipulated in subparagraph 34(c); and

(e) a written decision on the complaint indicated in subparagraph 34(d) of the present Regulations shall be issued by the Tax Administration within fifteen (15) business days from the date of the receipt of the complaint. The decision of the Tax Administration shall be final and not subject to appeal.

Section 37
Location of Field Control

(a) the taxpayer shall be under the obligation, if the field control is conducted in a premises occupied, owned, leased on controlled by the taxpayer under tax audit, to designate an appropriate working area at the disposal of the tax auditors, inspectors and or their representatives;

(b) at any time during the pendency of the field audit and during the business hours of the taxpayer, the auditors, inspectors and representatives of the Tax Administration shall have the right to enter and remain in the places indicated in subparagraph (a) where the taxpayer may be conducting its business;

(c) the taxpayer or a representative of the taxpayer with a valid power of attorney may be present at all times during the inspection of the books and records of the taxpayer by the auditors, inspectors and their representatives;

(d) if the taxpayer or representatives of the taxpayer are not present and the Tax Administration is prevented or delayed because of the absence of the taxpayer and or the representatives, a notation must be made accordingly in the audit record;

(f) if the field control is not conducted in the business premises of the taxpayer, the auditor, inspectors and or the representatives of the Tax Administration may inspect the taxpayer's business premises and enter the report of the inspection in the audit records; the taxpayer shall be under the obligation to participate in the fact finding process relevant to taxation in such manner as to give information and statements at the written request of the Tax Administration;

(g) the taxpayer shall be under the obligation to enable the tax auditors, inspectors and the representatives of the Tax Administration to obtain copies of relevant documents and or samples of goods (where appropriate);

(h) if the taxpayer is unable to attend the field control, the taxpayer shall delegate a person to act as his agent or representative;

(i) the failure and or neglect of the taxpayer to meet the obligation under subparagraph (h) above shall not delay the field audit;

(j) the auditors, inspectors and or representatives of the Tax Administration may by writing notice request data or other documentation from employees of the taxpayer or other persons controlling such data or documentation; and

(k) the employees and persons referred to in subparagraph (j) above shall be under the obligation to make the information or documentation at their disposal available to the Tax Administration.

Section 38
Time of Field Control

Where a field control is conducted at the premises of the taxpayer, it shall be conducted only during the working hours of the taxpayer, and exceptionally after working hours as well, if the purpose of the control requires this and if the taxpayer consents.

Section 39
Report

(a) at the conclusion of a tax audit or any material part of thereof, the Tax Administration shall prepare a final report of the field control;

(b) every page of the report must be marked by serial number and be signed ;

(c) a copy of the field control report shall be delivered to the taxpayer within twenty one (21) business days from the date of completion of the report by the Tax Administration;

(d) the taxpayer may submit a written objection against the report of the field control within fifteen (15) business days from the date of the receipt from the Tax Administration;

(e) the Tax Administration must review the taxpayer's complaint and if in the opinion of the Tax Administration there is new evidence and facts in the complaint that is sufficient to alter the factual and or legal basis of the report or any material parts thereof, the Tax Administration shall prepare additional report on such new evidence and or facts or of new legal evaluations and provide a copy to the taxpayer within forty five (45) days from the receipt of a written objection from the taxpayer; and

(f) if it is determined on the basis of the report or additional report on field control that there is no basis for amending the tax liability, the taxpayer shall be informed in writing, within thirty (30) days from the date of delivering the report, or the additional report, as the case may be.

Section 40
Commencement Date

The provisions of this Regulations shall be applied retroactively from January 1, 2013 and is effective for tax year commencing on or after January 1, 2013

Issued under my hand in exercise of my administrative and statutory authority pursuant to Section 19 of the Taxation of Bayu-Udan Contractors Act in Timor Leste, this day of January, 2013.

Her Excellency Emilia Pires
Minister of Finance
Timor-Leste

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Transfer Pricing Report

on the review of CRC Formula for the

BAYU-UNDAN Pipeline
&
DARWIN LNG Plant

EX. J 118

Draft - Version 2

March 24th 2013

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EX. J 119

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1. SCOPE OF THE REPORT

This report is exclusively prepared for **the National Directorate of Petroleum Revenue** of Timor-Leste (Client) by **Opus & Best LLC** (Consultant). an expert service firm in the field of oil and gas operations, including taxation, audit, transfer pricing and mergers & acquisitions. and substantial experience. The client has expressed to the Consultant that the Government of Timor Leste is reviewing the income-tax returns filed by the Upstream participants in the Bayu-Undan gas field and among other things the Government is looking at the reasonableness of the CRC formula in the pipeline charges paid by the participants to their related companies and claimed as a tax deductions in Timor-Leste. The client has sought the Consultant's assistance to review and opine on the reasonableness of the CRC formula that is used in relation to the pipeline tariff, based on the Consultant's industry experience.

The Consultant is required to critically assess and benchmark the CRC formula, (not the actual figures) as a stand alone subject. The Consultant is required to look at the formula from an economic and transfer pricing standpoints and not required to consider specifically the regulatory framework applicable in Timor Leste, more particularly in relation to Oil & Gas (O&G) activities and the Bayu-Undan gas project specifically.

EX. J 120

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2. APPROACH..(1/2)

The client has provided the Consultant with some information in relation to the project (listed in *Annexure 3*) which the Consultant has reviewed and relied on. **In the case at hand, the Consultant's main purpose is to determine whether the CRC formula in the pipeline tariff is determined based on arm's length principles**.

Application of the arm's length principle is based on a comparison of the conditions in a controlled/related party transaction with the conditions in transactions between independent/unrelated enterprises. Performing a benchmark of comparable arrangements between independent companies (Comparable Uncontrolled Price method) requires defining what a comparable arrangement actually is for the purposes of applying the arm's length principle.

Factors determining comparability include the characteristics of the property or services in question, the functions performed by the parties taking into account assets used and risks assumed, the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.

The subject of pipeline tariff is a matter of regulation in many countries across the world. In a number of countries, the government has setup a pipeline tariff regulator to set out and govern the pipeline industry and among other things, prescribe a system for pipeline tariffs. The regulator periodically requires pipeline operators to compute the tariff in accordance with these regulations and take approval of the regulator for the tariffs used. Usually, the tariff regulators thrive to maintain a good balance between protecting the customer from over-recovery of tariffs by the pipeline operator and at the same time ensure a fair and reasonable return and to the investor to invest in the pipeline. The Consultant has reviewed the tariff regulations from a mixed sample developed & developing countries (US, Australia, Europe, India, Ireland and South Africa). The Consultant believes that there is a degree of commonality among these regulations on the key principles that are used for determination of pipeline tariffs. For examples, these regimes prescribe using the cost of service principle, an allowed rate of return, an allowed recovery of capital costs via depreciation allowance etc.

In the Consultant's view, these key principles that underlie the tariff regimes reviewed serve as a good benchmark for the Consultant's objective of reviewing the CRC formula and the overall pipeline tariff structure for the Bayu-Undan pipeline. The Consultant's objective is not to review the actual tariff values or the actual margins earned by the Upstream participants/pipeline owners. In the remarks and conclusions, the Consultant has relied on the research documents listed in *Annexure 1*. These also include a small sample of model gas pipeline transportation arrangements apart from tariff regimes.

EX. J 121

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2. APPROACH..(2/2)

The OECD has done a substantial amount of work in the area of arm's length price determination. As per OECD, the Comparable Uncontrolled Price method is the best method of identifying the arm's length price of a transaction. It should be noted that despite numerous and detailed comparability factors listed by OECD that should be investigated in an ideal situation, publicly available information is most often significantly more limited in practice. The analysis that was performed by the Consultant attempted to identify, given this practical constraint, as closely comparable data on the key principles and agreements as possible. However the Consultant has not necessarily ensured perfect comparability, nor investigated each and every factor listed by the OECD.

After all, Timor Leste is not an OECD member country and the OECD guidelines and rules do not have official status of law in Timor Leste. It should be noted that the OECD itself recommends adopting a pragmatic approach: "*The identification of potential comparables has to be made with the objective of finding the most reliable data, recognizing that they will not always be perfect. For instance, independent transactions may be scarce in certain markets and industries. A pragmatic solution may need to be found, on a case-by-case basis, such as broadening the search and using information on uncontrolled transactions taking place in the same industry and a comparable geographical market, but performed by third parties that may have different business strategies, business models or other slightly different economic circumstances; information on uncontrolled transactions taking place in the same industry but in other geographical markets; or information on uncontrolled transactions taking place in the same geographical market but in other industries. The choice among these various options will depend on the facts and circumstances of the case, and in particular on the significance of the expected effects of comparability defects on the reliability of the analysis.*"

As stated by the OECD, the consideration charged in comparable transactions between independent enterprises in the same industry can be a guide, where this information is available, and a range of pricing may be appropriate (i.e. to some extent mitigate the level of inaccuracy).

In the Consultant's view, the approach of directly comparing the key principles used to determine the CRC and tariff structure with other arrangements is better and closer to the arm's length result given the scope of the s study, rather than undertaking a margin based analysis using the other methods such as Cost Plus Method, Resale Minus Method, Profit-Split Method or Transactional Net Margin Method. In the Consultant's view , such methods are only deductive and weak in reaching a conclusion that the CRC formula was arm's length by looking at the margins.

EX. J 122

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3. O&G BACKGROUND

The O&G industry is termed by some as a mixture of both unfortunate and happy coincidences, the complexities of which even industry participants struggle to forecast correctly. Whether on land or sea, the act of finding and producing hydrocarbons is expensive, complex, and generally not well understood by all. Apart from all the complications associated with the technical and commercial side of this industry, even financial and tax issues in the energy sector are extremely difficult to navigate.

Due to the fact that most multinational O&G companies are forced to stretch their supply chains across far flung places and exchange billions of dollars of commodities, equipment, engineering services and intangible/intellectual property (IP) among their controlled affiliates, transfer pricing risks are one of the largest tax issue faced by these companies. It is an issue that is being debated across the world also subject to greater level of scrutiny by Tax Administrations; and rightfully so.

The O&G companies focus on the acquisition, exploration and development of properties for the production of crude oil and natural gas from underground reservoirs- both onshore and offshore. This process generally takes several years to complete and each project is evaluated separately using project economics.

The gathering, processing, storage, and transmission of natural gas, and the gathering, storage, and transportation of crude oil are the main operations of the midstream sector. Crude oil and other products are transported internationally in barges or tankers on water, and on land by trucks, and pipelines. Natural gas typically moves via pipeline from the producer to the gatherer or transmission company, and then on to the distributor. These products are typically stored in bulk terminals, refinery tanks, pipeline tanks, underground salt domes, barges, tankers, and inland ship bunkers.

To understand the nature of intercompany services in the upstream segment of this industry, it is important to know that the commercial venture of exploring and producing hydrocarbons is typically carried out by multiple unrelated parties, each of whom has a financial interest in the property. The obligations of each party are governed by a number of contractual relationships, such as a joint operating agreement (JOA) and production sharing contract (PSC). A JOA generally governs the relationship between the working interest partners in a joint venture. The operator, typically the O&G company with the largest working interest in a property, has the benefit of being able to manage the project, providing technical resources, decision making and management services to the JOA.

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4. GAS PIPELINE PROJECTS

Like all infrastructure projects, Gas transportation pipelines associated with O&G industry are also characterized by high upfront investment that turns into sunk cost if the asset is not used. As a general rule, the owner would see whether his investment in the capital costs and the costs associated with operating the pipeline, including costs incurred in repairs and maintenance are all recoverable over the useful life of the pipeline. The owner also looks at the rate of return that his investment would bring him and compare that with his cost of capital – be it self-generated cash or borrowed cash. Due to the unique nature of each project, the costs of building pipelines are unique in a way and not directly comparable.

As such, the cost of building a gas pipeline depends on number of important factors:

- *Geographical* (distance, overhead, subsea, climate, terrain etc)
- *Technical* (thickness, pressure, entry and exit points, singular or network, etc)
- *Regulatory* (license to operate, taxes, duties, levies etc)
- *Financial* (debt/equity funding, credibility of the investor, assurance on returns etc)

Operating costs of a pipeline usually include:

- Manpower, materials, working capital etc necessary for operating the pipeline
- Cost of repairs & maintenance of the pipeline
- Customer Service related costs (incl metering, billing, accounting, etc)
- General and Admin costs

Other factors that affect pipeline costs can be:

- Regulatory framework for operating pipelines
- Market structure and competition

A fair system of pricing for gas transportation via pipeline must:

- give stimulation to safe & reliable gas supply
- make the project worthy of financial investment for debt or equity participants
- ensure a balanced end-user gas price

EX. J 124

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5. BAYU-UNDAN GAS FIELD

The Bayu-Undan gas field is situated in the Joint Petroleum Development Area (JPDA) in the Timor Gap. The field was discovered in 1995 and is located approximately 500km north-west of Darwin, Northern Territory (Australia) and approximately 250 kilometers off the southern coast of Timor Leste. It is equipoised at the boundaries of block 91-12 (60%) and 91-13 (40%), under Area A. The fields are located on the same 160km2 structure, in approximate depth of 80m of water.

The Bayu-Undan gas field is estimated to hold approximately 3.5 trillion cubic feet of gas and 500 million barrels of condensate and LPG. The 25x15km field will need approximately 26 wells over its lifetime to produce the reserves. The field life is estimated to be 25 years. Commercial production began in April 2004, delivering 115,000bpd of condensates and LPG.

ConocoPhillips is operator of the Bayu-Undan gas field with Production Sharing Contracts 03-12 and 03-13.

The gas has been developed in two phases :

- Phase I included a natural gas recycle project, in which condensate and natural gas liquids were separated and removed for sale, and dry natural gas was re-injected back into the reservoir until phase II (Darwin LNG) was ready to receive the hydrocarbons. Production from the first phase began in February 2004.

- Phase II of the development involved the installation of a natural gas pipeline from the field to Darwin, Australia, and construction of an LNG facility located at Wickham Point, Darwin. The Darwin LNG plant converts gas from the Bayu-Undan field into LNG for sale to Tokyo Electric and Tokyo Gas in Japan.

The first shipment of LNG was loaded in early 2006 and the plant was officially commissioned in June 2006.

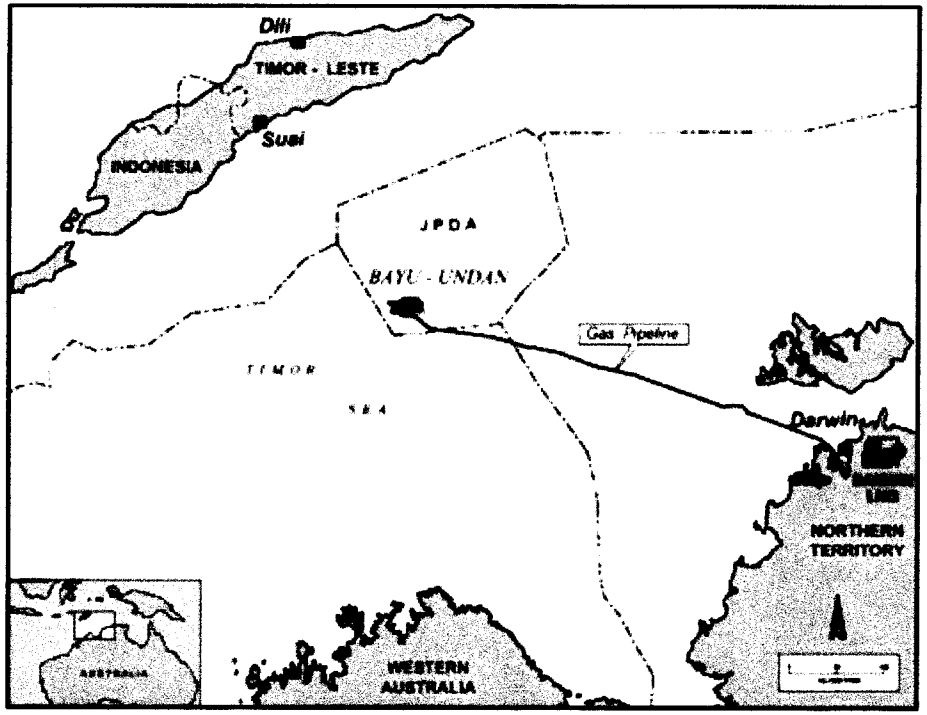
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6. BAYU-UNDAN PIPELINE (1/2)

A 502 km 26" subsea pipeline connects the Bayu-Undan Drilling, Production & Processing (DPP) Platform in the Timor Sea to the Wickham Point Liquefied Natural Gas (LNG) plant located in Darwin (Australia). The pipeline was at the time, the longest subsea pipeline ever installed in Australian waters.

The Darwin LNG plant was also officially opened in 2006. The plant employs a two trains in one design; it has a single above-ground tank for storage, with a working capacity of 188,000 m3. It produces at a rate of 3.5 MMt/y.



EX. J 126

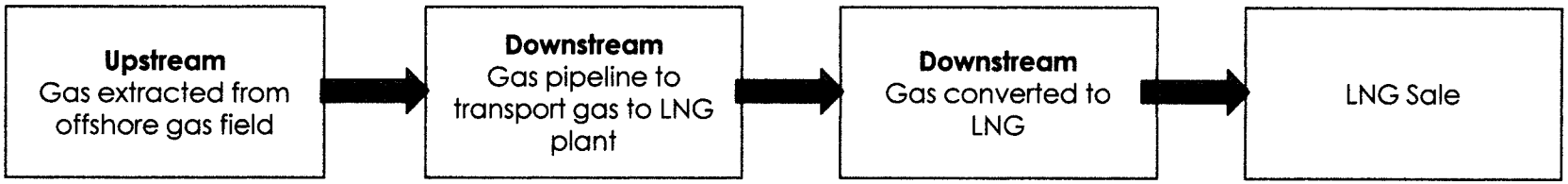
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6. BAYU-UNDAN PIPELINE..(2/2)

The pipeline ownership is in the form of an unincorporated joint venture between the following parties:

[illegible]	[illegible]
Conoco Philips	56.94
Inpex	11.38
Santos	11.49
Eni	10.99
Tokyo Electric	6.13
Tokyo Gas	3.07
Total	**100.00**

The same owners and/or their related companies own the Upstream gas business, the pipeline and the Darwin LNG plant. The ownership of these assets in similar proportions. Hence the Upstream and Downstream operations are among related parties. The key functions undertaken by each business are as depicted by the following diagram:



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7. PIPELINE TARIFF STRUCTURE

The owners of beneficial interest in the Bayu-Undan gas field have signed a long term Gas Transportation Agreement (GTA) on the following commercial terms with their related companies:

- The pipeline capacity is fixed and this is entirely booked by the gas owners for a term of 15 years on "take or pay" principle, subject to force majeure.

- The pipeline owner is responsible for transportation of gas from the Bayu-Undan gas field to the Delivery point in Darwin where the LNG plant is located. The risks associated with the gas title and gas marketing are still with the gas owner and they are not assumed by the pipeline owners. The pipeline owners essentially operate as the gas transportation service providers and are entitled to a tariff for providing the gas transportation service.

- The pipeline tariff agreed by the gas owners with their related parties under the GTA comprises of 2 parts:
  - Part 1 : Capacity Reservation Charge (CRC) to be calculated annually
  - Part 2 : Downstream Operating Costs Charge (DOCC)

- The DOCC operates on pass-through principle, ie the actual operations costs of the pipeline owner in relation to the transportation services and ongoing repairs and maintenance are sought as a reimbursement from the gas owners through the DOCC. (Review of DOCC is outside the Consultant's scope).

- The CRC on the other hand is a fixed recovery as per agreed formula which basically allows the pipeline owners to recover their capital costs, an 8% return on investment (unlevered) and the deemed tax on the return.

- After the initial 15 years, DOCC and CRC will be replaced by a Unit Tariff (UT).

EX. J 128

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8. CRC FORMULA : ASSUMPTIONS

The main principles set in the GTA and observed in the 2011 CRC calculations for the Bayu-Undan pipeline in relation to the pipeline CRC are:

- Date of Commencement : 1 January 2006
- Term : 15 Years
- Pipeline depreciation : 15 Years using Straight Line Method
- Allowed Rate of Return : 8% (unlevered, after tax)
- Australian Tax Rate : 30%
- Pipeline Capacity : 750,750 mmbtu/day
- Capital Costs : US$ 404.33 million (not defined in GTA but observed in 2011 CRC calculation)
- Abandonment Costs recovered in year 15 : US$12.22 million (2006 base escalated @2.5% per annum to reach US$17.7 million in 15 years)
- Escalation rate : CRC is escalated annually at a compounding escalation rate of 2.5% starting after the first12 months

<u>CRC Formula for initial 15 years as per GTA:</u>

Annual CRC = (a) Annual Depreciation + (b) RoR + (c) Income tax

Where

Annual Depreciation : Capital Costs/15

Income tax = 30% of (b)

CRC is determined via an iterative process to achieve a rate of 8% RoR

- Share of each gas owner's annual CRC is divided by the Annual Pipeline capacity and multiplied by the gas owner's share of booked capacity
- CRC is escalated annually at a compounding rate of 2.5% such the Net Cash Flows (NCF) from the term of 15 Years achieves the target rate of 8% return

EX. J 129

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9. CRC FORMULA - KEY OBSERVATIONS..(1/2)

From a review of the principles used to determine the CRC for the Bayu-Undan to Darwin pipeline and given the scope of this review and the Consultant's approach, the Consultant makes the following key observations:

- The tariff structure as per the GTA (using CRC + DOCC) allows the pipeline owner to recover (1) capital costs (2) RoR and (3) a deemed Australian Income tax on profits and (d) operating costs, including repairs and maintenance. Fundamentally, the tariff structure is set up on a "cost-of service" principle. This principle is typically used in pipeline tariff arrangements and broadly, setting a pipeline tariff arrangement using these principles can be considered as being arm's length, subject to the following comments on this and the next slide about how these principles have been applied :

- The Australian tax rate assumption of 30% matches the current Australian corporate tax rate. However there is no mechanism in the CRC formula in Schedule 7 to adjust the CRC rate if there is a change in the Australian rate of tax over 15 years.

- The application of the Cost of service principles in this GTA is too simplistic in some areas – it does not factor-in some important elements/details that is usually found in pipeline tariff arrangements. Depending on the assumptions that are made about these missing elements/details in the tariff formula, the recoverable tariff (and within that the CRC), can change materially over a period of 15 years as shown by the Consultant using some examples:

    - The CRC formula uses an unlevered rate of return of 8% and it does not factor-in the actual capital structure and the financing pattern of each of the pipeline owner. This can have a material impact on the recovery of income-tax through the CRC formula (Refer Slides 15 & 16).

    - The CRC formula assumes a fixed & flat rate of 8% RoR (unlevered, after-tax). There is no transparency in the GTA to show how the target rate of 8% RoR is arrived at? Usually, the industry practice is to allow recovery of the RoR in the pipeline tariff using the actual WACC calculations. WACC which is calculated by considering the actual or a deemed capital structure and it factors is the actual cost of equity and actual cost of debt of each owner. (Refer Slides 17-19).

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9. CRC FORMULA - KEY OBSERVATIONS..(2/2)

- There is no mechanism / control set up in the tariff formula to check on over / under-recovery of tariff via the CRC element. The over-under recovery of CRC are also specifically excluded from the definition of DOCC, thereby preventing any correction for over or under-recovery. As several assumptions are used in the calculation of CRC and actuals may be different, especially over the long project life of 15 years, it would be arm's length to include a mechanism for periodic review and correction for the CRC charge to prevent over recovery by the pipeline owner.

- There is no maximum cap (or a formula for cap) in the tariff structure to limit the maximum recovery of costs via the CRC formula to actual costs – this potentially allows the pipeline owner to recover more than his actual costs and thus earn more than the intended 8% RoR in this arrangement.

- There is no terminal or scarp value found in the 2011 CRC calculation at the end of project life of 15 years. It would be fair to assume a recovery of at least the working capital at the end of the project term, assuming this was included in the capital costs.

- The CRC formula is based on recovery of the entire capital cost of the pipeline over the tax useful life of 15 years. The CRC formula uses taxable life rather than the actual economic useful life of the pipeline. Tax depreciation rates (i.e. taxable life) often tend to work as an incentive and they do not necessarily indicate the actual useful life of the asset. If the useful life of the Bayu-Undan gas field is say 20-25 years, it is quite likely that this pipeline would also be useful for 20-25 years. In such a case, recovery of the entire capital cost cost in just 15 years via the CRC would result in "front loading" of costs, i.e. faster recovery of capital costs in years 1-15 with no recovery in years 16-25 as opposed to a more even and slower recovery of capital costs over the actual useful life (Refer Slides 20-21).

- Rather than a flat recovery of the CRC over the 15 years, the formula set in the GTA to determine the annual CRC uses a compounding escalation rate of 2.5% such that the CRC keeps escalating during the 15 years rather than remain flat and the owners recover 8% RoR based on such escalating CRC flows. The Consultant has not understood what is the justification to use an escalating CRC as opposed to a flat CRC when the owner incurs all the capital costs upfront and the actual operating costs (which may subject to inflation) are recovered separately via the DOCC. (Refer Slide 22).

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10. ADDITIONAL REMARKS

These remarks are outside the Consultant's scope of review, but in the Consultant's view, these additional remarks are important in the context of whether the actual CRC and the pipeline tariff for this project are reasonable:

- It is important to review what is included in the capital costs assumption of US$404.33 and if this is the agreed capital cost for tariff purposes, then what is the actual capital cost of the pipeline using sound accounting principles.

- It is a matter of negotiation whether the income tax component paid via the CRC should be the deemed income tax as in done in this GTA or the actual income tax borne by the pipeline owner. There are no set rules on this but it would be good to review in particular if the pipeline owner is entitled to any special tax regime or special tax incentives and what are the key factors that cause the difference between the actual tax bill and the deemed tax paid via tariff.

- The actual capital structure for the project and a review of the WACC of the owner is necessary to benchmark if the 8% RoR is reasonable.

- It is important to review the actual financial results of the pipeline owner to compare his actual rate of return on capital versus the target rate of 8%. If the pipeline owners are making significantly higher returns that the 8% target, this could be due to incorrect tariff assumptions.

- The pipeline tariff is based on the assumption that the pipeline is dedicated only to the Bayu-Undan gas field only and that the maximum capacity of the pipeline is 750,750 mmbtu/day for the entire project term. This assumption does not consider the possibility to use to feed gas from any other/nearing fields using an interconnection with this pipeline and increase in the pipeline capacity using compression technology. Such a possibility would significantly change the position on tariffs that should be recovered from the Bayu-Undan gas field.

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11. DETAILED EXPLANATION
(I) CAPITAL STRUCTURE..(1/2)

- A pipeline's capital structure is a representation of how a pipeline owner has financed his investment. It is represented as a ratio of a pipeline's debt and equity. For example, a pipeline owner which has financed his investment of say $10 million with $6 million of debt and $4 million of equity, is referred to as having a 60%/40% debt-equity capitalization ratio.

- Debt-equity ratios for different pipeline owners may be different as each owner would choose his own funding plan.

- Tariff or CRC of a pipeline that is 100% funded by equity is costlier than that of a pipeline that is funded by debt and equity.

- The key reason is that the recovery of "income tax" factor in the case of an equity funded pipeline is higher than in the case of a pipeline that is funded with both debt and equity. The pipeline owner is able to get an income tax deduction for the return on debt (interest) as this is a tax deductible expense. Income tax recovery is in principle linked to the return on equity and therefore the higher the equity, the higher would be the cost of income tax in the tariff.

- The analysis given on the *next slide*, shows the difference in pre-tax return required to provide an 8% post tax RoR to the pipeline owner using different capital structures. It can be seen from the examples that the highest pre-tax return required (making it the most expensive tariff) is in the unlevered case where 100% equity funding is assumed.

- The CRC formula for the Bayu-Undan pipeline ignores reference to the the actual capital structure used by each of the pipeline owner and assumes that the entire project is equity funded. In reality, if this is not the case and the pipeline is indeed funded partially by debt then the assumption used in the calculation of CRC would result in excess pipeline tariff and higher returns to the pipeline owners.

- While looking at the funding pattern of each pipeline owner it is important to see whether the owner group is partially funded by debt or if the debt for this investment has been taken by the owner indirectly, at a different level within his overall group. This situation would be different for each pipeline owner.

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11. DETAILED EXPLANATION
(I) CAPITAL STRUCTURE..(2/2)

Analysis of the 8% RoR formula

Impact of Capital Structure on RoR (Unlevered versus Levered return)

Pipeline Capex	404.33
LNG Capex	1,308.88
Total Capex	**1,713.21**

	Asset Base	Debt:Equity	RoR	Annual return			
Equity Funding	1713.21	100%	8.00%	137.06			
Debt Funding	0.00	0%	8.00%	0.00			
Allowed Return (post tax)				137.06	8.00%	WACC	
Income Tax (allowed on return on equity)				41.12	30%	Oz tax rate	
Required Pre-tax return for 8% post tax target				**178.17**	10.40%	RoR	GTA position

		Debt:Equity	RoR				
Equity Funding	513.96	30%	8.00%	41.12			
Debt Funding	1199.25	70%	8.00%	95.94			
Return required & Allowed Return				137.06	8.00%	WACC	
Income Tax (allowed on return on equity)				12.34	30%	Oz tax rate	
Required Pre-tax return for 8% post tax target				**149.39**	8.72%	RoR	Scenario 1 : Assuming 70% & both debt & equity cost @8%

		Debt:Equity	RoR				
Equity Funding	685.29	40%	11.00%	75.38			
Debt Funding	1027.93	60%	6.00%	61.68			
Return required & Allowed Return				137.06	8.00%	WACC	
Income Tax (allowed on return on equity)				22.61	30%	Oz tax rate	
Required Pre-tax return for 8% post tax target				**159.67**	9.32%	RoR	Scenario 2 : Assuming 60% debt @ 6% & equity @11%

Conclusion: In all the above scenarios the post tax RoR is 8% but the pretax RoR required to reach the target of 8% is highest in the unlevered case where there is no debt assumed. This is because interest on debt is a tax deductible expense and it reduces the income tax component in the post tax RoR.

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11. DETAILED EXPLANATION
(II) RATE OF RETURN..(1/3)

The allowed Rate of Return (RoR) on invested capital, is of utmost importance in determination of the tariff for any pipeline project or for that matter any infrastructure project. The RoR is based on the risks assumed and determines the reward or return for assuming those risks.

Under the pipeline tariff regimes usually, RoR is determined by computing the Weighted Average Cost of Capital of the investor (WACC). The WACC is derived from the investor's cost of capital, determined by employing the Capital Asset Pricing Model ('CAPM'), and from the investor's cost of debt. The CAPM model is an asset pricing model which is a core tenet of modern portfolio theory. The use of CAPM based WACC calculations is very common in pipeline tariff determination and other forms of infrastructure.

In the GTA for Bayu-Undan pipeline, the RoR is assumed at a fixed rate of 8% (unlevered and after tax). The Consultant does not know what is the reason for using a flat rate as opposed to putting a formula for RoR within the CRC. WACC may be different for different participants so the allowed RoR may be different for each owner. The Consultant does not have the financial data to compute the WACC for each of the owners. Hence the Consultant has described that from an arm's length perspective, the following principles are used in the industry to determine the appropriate WACC and RoR to be recovered through Tariff :

RoR is usually set as the weighted average of the costs of the different components of financing, with the weights generally based on the market value of each component. The Weighted Average Cost of Capital (WACC) of the investment is computed via the following equation, taking into account the tax impact on financing by debt:

$$WACC = R_e * E/(E+D) + R_d * (1-t) * D/(E+D)$$

where:

R_e stands for the cost of Equity

R_d stands for the cost of Debt

E stands for the Equity value

D stands for the Debt value

t stands for the corporate tax rate

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11. DETAILED EXPLANATION
(II) RATE OF RETURN..(2/3)

Determination of the rate of return on the equity capital:

The definition of risk

According to the CAPM model, the total risk borne by an investor can be obtained by summing the systematic and specific risks. CAPM differentiates systematic from specific risk. Systematic risk refers to the risk of holding the market portfolio. As the market moves, each individual asset is more or less affected. To the extent that any asset participates in such general market moves, that asset entails systematic risk. Specific risk is the risk which is unique to an individual asset. It represents the component of an asset's return which is uncorrelated with general market moves.

The CAPM formula

The expected rate of return on the market is computed via the following equation:

$R_e = R_f + \beta_i * [E(R_m) - R_f]$

where:

R_e stands for the required rate of return on equity

R_f stands for the risk free rate of return

β_i stands for the Beta of the company

$[E(R_m) - R_f]$ stands for the market premium

Risk free rate of return

Since government securities are considered not to contain any default risk, their yields are a generally accepted proxy for a risk-free rate.

The Beta coefficient

The beta is a yardstick for comparing the volatility of the investment in a specific company of a specific industry to the investment in a broad portfolio of companies as a whole. The beta coefficient can be obtained either from known databases where samples of comparable public companies have been compiled or it can be calculated according to the available market data.

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11. DETAILED EXPLANATION
(II) RATE OF RETURN..(3/3)

Determination of the rate of return on the equity capital..(cont'd)

The market premium

The equity premium is represented by the expected return, in excess of the risk free rate, which investors generally require for investing in stocks. There are three ways of estimating the market risk premium in the CAPM model:

- Large investors can be surveyed about their expectations for the future;
- the actual premiums earned over a past period can be obtained from historical data; or
- the implied premium can be extracted from current market data.

The size premium

Analyses of the return of listed, small-size companies show that they yield higher returns than the ones resulting from the CAPM model. These analyses imply that the measure of the risk used in the CAPM model, i.e. the Beta coefficient, underestimate the actual risk of small-size companies. Indeed, small-size companies bear some specific risks, which are linked to their size (higher credit risk, lack of resources to adjust to competition, lack of control over product and demand, etc.). Thus, small-size companies are more sensitive to economic risks, which results in the expectation of a higher return from investors. A size premium may be applied, in order to take into account the size of the company.

Determination of the cost of debt

The cost of debt measures the current cost to the owner of borrowing funds to finance his investments. In general terms, it should be a function of the default risk that a lender perceives in the owner. As the perceived default risk increases, lenders will charge higher default spread (on top of the risk free rate) to lend to the owner. The cost of debt can be determined as:

- If the owner has bonds outstanding, and the bonds are traded, the yield to maturity on a long-term, straight (no special features) bond can be used as the interest rate.
- If the owner is rated, the rating and a typical default spread on bonds with that rating can be used to estimate the cost of debt.
- If the owner is not rated, but has recently borrowed long term from a bank, the interest rate on the borrowing can be used
- If the owner is not rated and did not recently borrow long term from a bank, an estimate synthetic rating for the company can be used to arrive at a default spread and a cost of debt.

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11. DETAILED EXPLANATION
(III) DEPRECIATION..(1/2)

- In fixing pipeline tariffs, capital costs are allowed to be recovered generally via Straight Line Method depreciation formula. The SLM divides the capital costs over the useful life of the assets. The useful life is determined by testing the physical and economic life of the assets.

- In the case of pipelines, they usually have a long physically life of at least 30+ years and it can be extended even further by repairs and maintenance. The economic life on the other hand is dependent on the economic usefulness of the pipeline. It is no doubt that the Bayu-Undan to Darwin pipeline is dedicated only to transport the feed gas from Bayu-Undan gas field to the Darwin LNG plant. Currently, the pipeline has no other customer. Unless this position changes in the future, the economic life of the pipeline can be assessed as linked with the economic life of the gas field itself. Since gas reserves in the gas field are considered to be finite, the pipeline life would also be finite.

- As long as there is gas available for commercial production in the gas field and it continues to be commercially extracted, the pipeline asset will remain useful. On this basis, if one considers a useful life of say 25 years for the Bayu-Undan gas field, the pipeline would also have a useful life of 25 years.

- The CRC formula in the GTA is based on recovery of the entire capital cost of the pipeline over the taxable useful life of 15 years. The formula uses the tax depreciation life rather than the actual economic useful life of the pipeline.

- Tax policy defers from country to country and taxation rates and tax depreciation rules are driven by public policy of a government. Governments, tend to use tax depreciation rates as an incentive and these rates do not necessarily indicate the actual useful life of the asset.

- For Many countries where infrastructure development is important on the economic agenda of the government, they may choose to incentivize the taxpayers by allowing accelerated or enhanced tax depreciation expense on their investment so as to reduce their tax bill and improve their post-tax returns. In some cases, tax depreciation allowance can be as high as 100% in the year of investment in a single year or more than 100% of the amount invested as an added incentive. However, in such cases, it does not mean that the useful economic life of the asset is just 1 year. Thus tax depreciation is not the most appropriate measure of the useful life of the asset.

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11. DETAILED EXPLANATION
(III) DEPRECIATION..(2/2)

- Recovery of the entire capital cost cost in just 15 years via the CRC has resulted in "front loading" of recovery of the investment costs, ie speedier recovery of entire capital costs in years 1-15 with nothing left to be recovered in the later years as opposed to a more even or balanced recovery of the capital costs over the actual useful life of the gas field.

- This puts a heavy burden of cost on the gas revenues for the years 1-15 and cause of an accounting mismatch of cost & revenue over the project life. The Consultant has simulated the effect of a slower depreciation of the capital costs over 25 years. The analysis is given in *Annexure 2* and it can be seen that in this example, the CRC charge will reduce in years 1-15 by is the assets are depreciated over 25 years. The trend would be the same if the useful economic life of the pipeline is seen as anything more than 15 years.

EX. J 139

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11. PIPELINE - DETAILED EXPLANATION
(IV) ESCALATION CLAUSE

Rather than a flat recovery of the CRC over the 15 years, the formula set in the GTA to determine the annual CRC uses a compounding escalation rate of 2.5% such that the CRC keeps escalating during the 15 years rather than remain flat and the owners recover 8% RoR based on such escalating CRC flows.

The Consultant has not understood, what is the justification to use an escalating CRC as opposed to a flat CRC when the pipeline owner incurs all the capital costs upfront and the actual operating costs (which may subject to inflation) are recovered separately via the DOCC.

The Consultant has simulated the effect of removing such an escalation and still ensuring that the owners gets 8% RoR over the project life of 15 years. The analysis is given in *Annexure 2* and it can be seen from the example, that although the CRC will increase in the initial years as opposed to a sliding CRC, the overall CRC charge will reduce over the 15 years project term, if there is no compounded escalation of the CRC @ 2.5% per annum as done in the GTA formula.

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DARWIN LNG PLANT - ANALYSES
INDEX

S1	Approach
S2	Darwin LNG plant
S3	LNG Plant Tariff Structure
S4	CRC formula : Assumptions
S5	CRC formula : Observations

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S1 - DARWIN LNG PLANT APPROACH

The client has provided the consultant with the **Feed Gas Sale and Purchase Agreement dated 4th June 2003, Copies of PSCS 03-13 AND 03-13, Income Tax returns** and materials explaining the **Calculation of the CRC charge for the LNG plant**, which the consultant has reviewed and relied on. The consultant's main objective is to determine whether the CRC formula in this agreement is reasonable from an arm's length perspective, under internationally recognized transfer pricing principles.

Similar to the analyses performed on the pipeline in the prior section, application of the arm's length principle is based on a comparison of the conditions in a controlled/related party transaction with the conditions in transactions between independent enterprises. Performing a benchmark of comparable arrangements between independent companies (Comparable Uncontrolled Price method) requires defining what a comparable arrangement actually is for the purposes of applying the arm's length principle.

As compared to the pipeline industry, the LNG industry is still relatively new and in a growing phase. The subject of LNG liquefaction is as such, not a matter of regulation across the world as in the case of pipelines. Governments across the world have not yet established any regulator who would set out and govern the LNG liquefaction industry. The consultant has attempted to search for a representative sample of LNG liquefaction arrangements to benchmark the CRC formula in this case, however the consultant has not been successful in getting meaningful comparables which can be considered as benchmarks for this exercise.

EX. J 142

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S1 - DARWIN LNG PLANT
APPROACH - CONTINUED

As such, the consultant believes that each LNG plant is unique in its feature and since there are a number of factors that distinguish two LNG plants – they cannot be compared directly with each other.

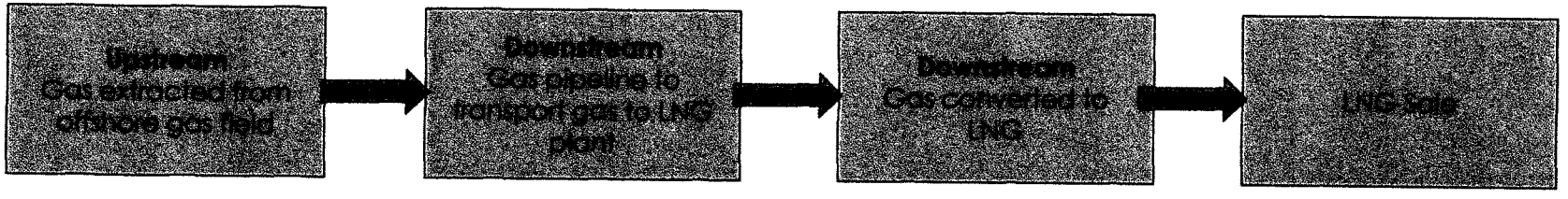
In the consultant's view, since the CRC formula for the LNG plant is created in a similar way to the CRC formula for the Bayu-Undan pipeline, some of the key economic principles that underlie the consultant's comments in relation to the tariff for the pipeline can also be applied possibly to the CRC formula for the LNG plant in the absence of any more direct comparable data.

EX. J 143

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S2. DARWIN LNG PLANT..(1/2)

As identified in the main report, the same owners and/or their related companies own the Upstream gas business, the pipeline and the Darwin LNG plant. The ownership of these assets in similar proportions. Hence the Upstream and Downstream operations are among related parties. The key functions undertaken by each business are as depicted by the following diagram:



The Darwin LNG plant ownership is in the form of an incorporated joint venture between the following parties:

ConocoPhillips Pipeline Australia Pty Ltd	56.94%
Inpex DLNGPL Pty Ltd	11.38%
Santos (Darwin LNG) Pty Ltd	11.49%
Eni Gas & Power LNG Australia B.V.	10.99%
TEPCO Darwin LNG Pty Ltd	6.13%
Tokyo Gas Darwin LNG Pty Ltd	3.07%
Total	100.00

EX. J 144

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S2 - DARWIN LNG PLANT..(2/2)

The Darwin LNG plant features:

- A 92m-diameter, 47m-high LNG storage tank to hold up to 188,000m³ of gas
- LNG process area – for treating and liquefying raw gas
- Marine jetty for delivering liquefied gas to cargo ships for transportation

The LNG plant processes the natural gas and cools and compresses it for storage in an LNG tank prior to export. The plant infrastructure includes a smaller single LNG processing train with a normal capacity of 3.24mtpa.

Philips optimized cascade LNG process liquefaction technology is used in the project. This technology was also used in the Conoco Phillips Kenai LNG plant in Alaska for the first time and in the Atlantic LNG facility in Trinidad. The LNG plant uses low-emission, aero-derivative-designed high-efficient gas turbines for refrigerant drivers.

The pipeline and LNG plant enable Timor Leste and Australia to commercialize the hydrocarbon resources within the Joint Petroleum Development Area (JPDA). In February 2006, the first tanker with liquid natural gas embarked from the LNG plant. The Darwin Harbour is now a major international gas hub in Australia.

EX. J 145

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S3 - LNG PLANT - TARIFF STRUCTURE

The owners of beneficial interest in the Bayu-Undan gas field have signed a Feed Gas Sale and Purchase Agreement (FGSPA) with Darwin LNG, which is their related company, on the following commercial terms :

- The LNG liquefaction plant capacity is fixed and this is entirely booked by the gas owners for a term of 15 years on "take or pay" principle, subject to force majeure.

- While the FGSPA is in form a sale and purchase agreement, in substance it is a liquefaction services agreement. Under the FGSPA, Darwin LNG will in substance provide liquefaction services to the Upstream Participants. In form, Darwin LNG will purchase feed gas from the Upstream Participants, liquefy the feed gas into LNG and on-sell the LNG on agreed terms.

- The risks associated with the gas title, pricing and gas marketing are still with the gas owner as such and they are not assumed by Darwin LNG, which essentially operates as the liquefaction service provider.

- The tariff agreed by the gas owners with Darwin LNG under the FGSPA comprises of 2 parts:
  - Part 1 : Capacity Reservation Charge (CRC) to be calculated annually
  - Part 2 : Downstream Operating Costs Charge (DOCC)

EX. J 146

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S3 - LNG PLANT TARIFF STRUCTURE - CONTINUED

- The DOCC operates on pass-through principle, i.e. the actual operations costs of Darwin LNG in relation to the liquefaction services and ongoing repairs and maintenance are sought as a reimbursement from the gas owners through the DOCC. (Review of DOCC is outside the consultant's scope).

- The CRC on the other hand is a fixed recovery as per agreed formula which basically allows Darwin LNG to recover the capital costs, an 8% return on investment (unlevered) and the deemed tax on the return.

- After the initial 15 years, DOCC and CRC will be replaced by a Unit Tariff (UT).

EX. J 147

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S4 - LNG PLANT – CRC FORMULA : ASSUMPTIONS

The main principles set in the FGSPA and observed in the 2011 CRC calculations for the Darwin LNG plant in relation to the LNG liquefaction CRC are:

- Date of Commencement : 1 January 2006
- Term : 15 Years
- Plant depreciation : 15 Years using Straight Line Method
- Allowed Rate of Return : 8% (unlevered, after tax)
- Australian Tax Rate : 30%

- Annual LNG Plant Capacity : As mentioned below:

First Year :	70,834,500 mmbtu
Second Year :	94,446,000 mmbtu
Third Year :	118,057,500 mmbtu
Fourth Year onwards :	157,410,000 mmbtu

- Capital Costs : US$ 1309 million (not defined in FGSPA but observed in 2011 CRC calculation)

- Abandonment Costs recovered in year 15 : US$ 152.01 million (2006 base escalated @2.5% per annum to reach US$ 220.16 million in 15 years)

EX. J 148

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S4 - LNG PLANT - CRC FORMULA : ASSUMPTIONS - CONTINUED

- Escalation rate : CRC is escalated annually at a compounding escalation rate of 2.5% starting after the first12 months

CRC Formula for initial 15 years as per FGSPA:

Annual CRC = (a) Annual Depreciation + (b) RoR + (c) Income tax

Where

Annual Depreciation : Capital Costs/15

Income tax = 30% of (b)

CRC is determined via an iterative process to achieve a rate of 8% RoR

- Share of each gas owner's annual CRC is divided by the Annual Plant capacity and multiplied by the gas owner's share of booked capacity

- CRC is escalated annually at a compounding rate of 2.5% such the Net Cash Flows (NCF) from the term of 15 Years achieves the target rate of 8% return

EX. J 149

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S5 – LNG PLANT
CRC FORMULA: OBSERVATIONS

The principles used to determine the CRC for liquefaction service provided by the Darwin LNG plant are similar to the CRC for the Bayu-Undan to Darwin pipeline and given the scope of this review and the consultant's approach, the consultant makes the same broad observations on principles used for the LNG CRC formula as his observations for the pipeline CRC formula.

- The Australian tax rate assumption of 30% matches the current Australian corporate tax rate. However there is no mechanism in the CRC formula to adjust the CRC rate if there is a change in the Australian rate of tax over 15 years.

- Depending on the assumptions that are made about the elements/details that comprise the CRC formula, the recoverable tariff can change materially over a period of 15 years as shown by the consultant using some examples in the main report. The consultant makes the same observations on this CRC formula as in the main report :

  - The CRC formula uses an unlevered rate of return of 8% and it does not factor-in the actual capital structure and the financing pattern of each of the investors in Darwin LNG. This can have a material impact on the recovery of income-tax through the CRC formula.

  - The CRC formula assumes a fixed & flat rate of 8% RoR (unlevered, after-tax) instead of using a RoR determined using the WACC.

EX. J 150

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S5 – LNG PLANT
CRC FORMULA: OBSERVATIONS - CONTINUED

- There is no mechanism / control set up in the tariff formula to check on over / under-recovery of tariff via the CRC element. There is also no maximum cap (or a formula for cap) in the tariff structure to limit the maximum recovery of costs like in the case of pipeline.

- There is no terminal or scarp value found in the 2011 CRC calculation at the end of project life of 15 years. It would be fair to assume a recovery of at least the working capital at the end of the project term, assuming this was included in the capital costs.

- Like the pipeline, the CRC formula is based on recovery of the entire capital cost of the LNG plant over 15 years rather than the actual useful economic life of the plant which can be seen as "front-loading" of costs.

- The consultant has not understood what is the justification to use an escalating CRC as opposed to a flat CRC when the owner incurs all the capital costs upfront and the actual operating costs are recovered separately via the DOCC like the pipeline.

- Like the pipeline tariff, the consultant has not been able to benchmark the above comments with other LNG liquefaction agreements or tariff regimes for this industry but the comments are based on sound economic principles in the consultant's views and therefore important. For details on each of the above points, refer to the analyses in the above section for the pipeline report.

EX. J 151

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CONCLUSIONS

In the Consultant's view, although the pipeline and LNG Plant tariff formula arguably uses basically arm's length principles of cost of service, there is a bandwidth available on how these principles are applied in practice and what assumptions are used to calculate the yearly CRC charge. As the Consultant has demonstrated, the CRC is quite sensitive to these assumptions and can vary materially depending on how the principle is applied or what assumption is used.

PIPELINE

As explained by the Consultant, some of the assumptions used in the agreements could be questioned if the tariff for this pipeline was to be tested under the sample regulations and tariff agreements listed by the Consultant. The Consultant believes that the gas owners and the pipeline owners, in an arm's length (non related party) situation could have strived more to put the following precisions in the CRC formula:

- RoR
  - Recognize the actual capital structure used by the owner to fund the pipeline investment, ie using a levered RoR as opposed to assuming 100% equity funding (unlevered RoR case) which is most expensive
  - Link the RoR in the formula to the actual WACC of the pipeline investors rather than allowing a fixed rate, although a rate could be fixed if this was negotiated and agreed

EX. J 152

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CONCLUSIONS - CONTINUED

PIPELINE - continued

- Longer depreciation of assets to slow down capital cost recovery rather than allowing owners to recover full costs in 15 years when the economic life is 25 years
- Not choose to use a fixed compounding escalation rate for CRC
- Put some mechanisms in the formula to prevent over/under recoveries due to the variance between assumptions and actuals

EX. J 153

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12. CONCLUSIONS - CONTINUED

LNG Plant

For the LNG Plant, we summarize our observations conclusions as follows:

- The CRC formula uses an unlevered rate of return of 8% and it does not factor-in the actual capital structure and the financing pattern of each of the investors in Darwin LNG. This can have a material impact on the recovery of income-tax through the CRC formula.

- The CRC formula assumes a fixed & flat rate of 8% RoR (unlevered, after-tax) instead of using a RoR determined using the WACC.

- There is no mechanism / control set up in the tariff formula to check on over / under-recovery of tariff via the CRC element. There is also no maximum cap (or a formula for cap) in the tariff structure to limit the maximum recovery of costs like in the case of pipeline.

- There is no terminal or scarp value found in the 2011 CRC calculation at the end of project life of 15 years. It would be fair to assume a recovery of at least the working capital at the end of the project term, assuming this was included in the capital costs.

- Like the pipeline, the CRC formula is based on recovery of the entire capital cost of the LNG plant over 15 years rather than the actual useful economic life of the plant which can be seen as "front-loading" of costs.

EX. J 154

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CONCLUSIONS - CONTINUED

LNG Plant - continued

- The consultant does not understand the justification for the use of an escalating CRC as opposed to a flat CRC when the owner incurs all the capital costs upfront and the actual operating costs are recovered separately via the DOCC like the pipeline.
- Considering the CRC calculations , it appears that the Contractors are compensated far more than what they would have earned in an arm's length transaction.

EX. J 155

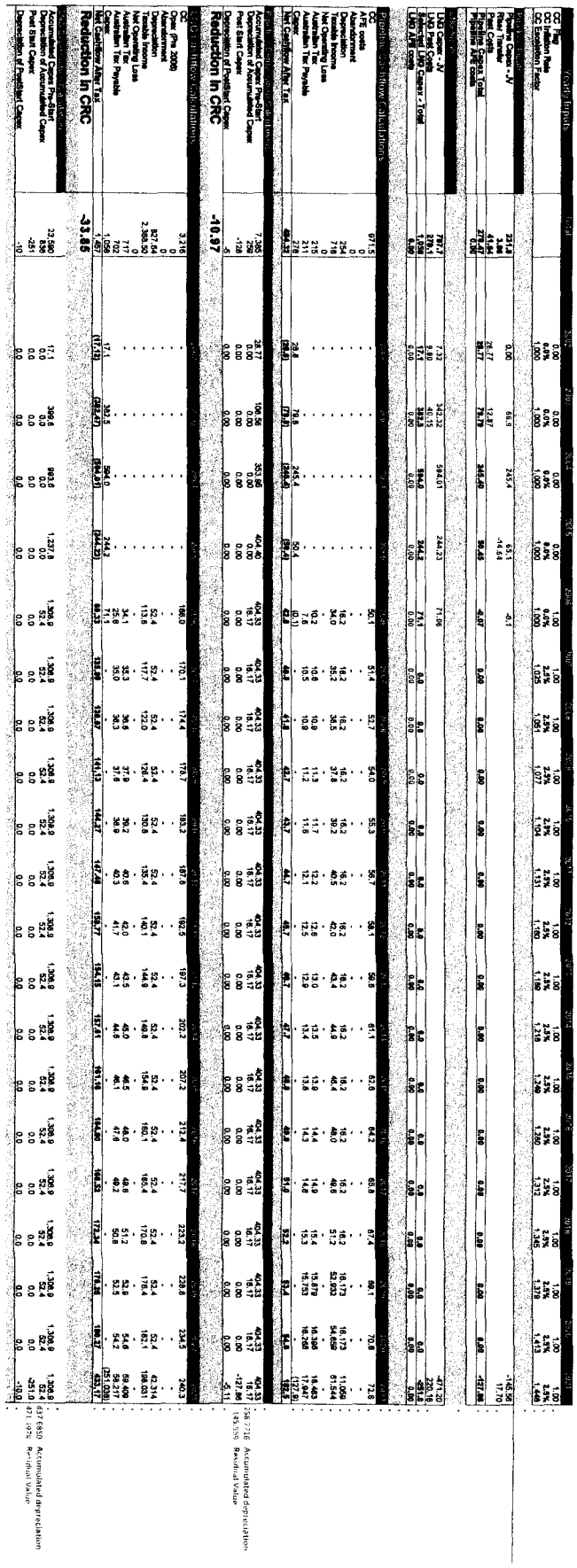
Case 3:15-cr-00196-FLW Document 49-12 Filed 09/28/16 Page 156 of 503 PageID: 1085

DISCLAIMERS

- Opus & Best LLC relied upon the accuracy of the information, including data provided by the client and drew rational conclusions from same. Consultant does not bear any responsibility for the exactitude of such information and or data. Consultant disclaims and liability for ay incorrect or inaccurate information provided by the client relating to the Bayu-Undan gas project
- Other than testing the comparability of the CRC formula and benchmarking same against those of independent enterprises, for the purposes of determining the arm's length profitability of the Contractors, the Consultant does not vouch for the sufficiency or adequacy of this report for any such purpose.
- The observations and conclusions in this report are the views and opinions of the Consultant. After all, views are views and it is possible that others may have different views on the exact same subjects. It is also possible that others may not necessarily agree with the Consultant's views and opinions and the Consultant does not make representations or warranties in this regard.
- The Consultant also takes no responsibility to update this report at any time.
- The Consultant has solely relied entirely on the following information provided by the National Directorate of Petroleum Revenue for the purpose of this exercise:
  - *Gas Transportation Agreement*
  - *Copy of Pipeline CRC Calculation Sheet*
  - *CRC principles document*
  - Income Tax Returns
  - Gas Sale & Purchase Agreement
- In addition, the Consultant has relied on publicly available information that the Consultant has managed to find from the internet for doing this analysis, and which is identified on **Slide X**. The Consultant has not independently verified any such information.

EX. J 156

Bayu-Undan Pipeline & LNG Plant CC Calculation_25 yrs Depreciation (Residual value assumed as recovered in Year 15 after reducing abandonment costs)



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ANNEXURES

- Annexure 1 : List of research documents attached
- Annexure 2 : CRC Sensitivity Examples
- Annexure 3 : List of information from the client

EX. J 158

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EX. J 159

Bayu-Undan Pipeline & LNG Plant CC Calculation

General Inputs	Range Name	Unit	Case
Commencement Year	start_year	Year	2006
Project Life for Depreciation and CC Calc	proj_life	Years	18
Australian Income Tax Rate	AustTax	%	30%
Proportion of Tax Payable This Year	CurrentTax	%	75%
Proportion of Tax Payable Next Year	FollowingTax	%	25%
Pipeline Abandonment Cost (AUD)			16.56
2006 AUD/USD Exchange Rate for Aband Cost			0.74
Pipeline Abandonment Cost	PipeAband	$mm 2006	17.70
LNG Abandonment Cost	GasAband	$mm 2006	220.00
Pipeline CC (2006 Dollars)	PipeCRC	$mm 2006	63.25
Pipeline post-tax IRR Actual		%	8.000%
Pipeline post-tax IRR Allowed		%	8.00%
Pipeline IRR Difference	PipeIRRDiff	%	0%
LNG CC (2006 Dollars)	GasCRC	$mm 2006	209.23
LNG post-tax IRR Actual		%	8.000%
LNG post-tax IRR Allowed		%	8.00%
LNG IRR Difference	GasIRRDiff	%	0%

63,245,000.00 5,270,416.67

209,225,000.00 17,435,416.67

Yearly Inputs	Total	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
CC Flag		0.00	0.00	0.00	0.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.00
CC Inflation Rate		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
CC Escalation Factor		1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Pipeline																					
Pipeline Capex - JV	377.3	0.00	66.9	245.4	65.1	-0.1															0.00
Riser Transfer	-14.64				-14.64																
Past Costs	41.84	28.77	12.97																		
Pipeline Capex Total	404.33	28.77	79.79	245.40	50.45	-0.07	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Pipeline AFE costs	0.00																				
Plant																					
LNG Capex - JV	1,258.9	7.32	342.32	584.61	244.23	71.06															0.00
LNG Past Costs	40.8	9.80	40.15																		
Selected LNG Capex - Total	1,298	17.1	382.5	584.6	244.2	71.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
LNG AFE costs	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Pipeline Cashflow Calculations	Total	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
CC	948.7	-	-	-	-	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	-
AFE costs	0	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Abandonment	18	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	17.696
Depreciation	404	-	-	-	-	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0	27.0	26.955	26.955	-
Taxable Income	527	-	-	-	-	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.3	36.290	36.290	(17.696)
Net Operating Loss	-18	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(17.696)
Australian Tax	163	-	-	-	-	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.887	10.887	-
Australian Tax Payable	163		-	-	-	8.2	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.9	10.887	10.887	2.722
Capex	404	28.8	79.8	245.4	50.4	(0.1)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Cashflow After Tax	362.38	(28.8)	(79.8)	(245.4)	(50.4)	55.1	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	52.4	(20.4)
Reduction in CRC	**-33.83**																				
Depreciation Calculations																					
Accumulated Capex Pre-Start	7.365	28.77	108.56	353.95	404.40	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33	404.33
Depreciation of Accumulated Capex	404	0.00	0.00	0.00	0.00	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	26.96	0.00
Post Start Capex	0	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Depreciation of PostStart Capex	0	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

404.3306
0.0000

LNG Cashflow Calculations	Total	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
CC	3,138	-	-	-	-	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	209.2	-
Opex (Pre 2008)	0	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Abandonment	220	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	220.000
Depreciation	1,308.88	-	-	-	-	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	-
Taxable Income	1,609.49	-	-	-	-	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	122.0	(220.000)
Net Operating Loss	-220	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	(220.000)
Australian Tax	549	-	-	-	-	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	-
Australian Tax Payable	549		-	-	-	27.4	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	36.6	9.147
Capex	1,309	17.1	382.5	584.0	244.2	71.1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Cashflow After Tax	1,081	(17.12)	(382.47)	(584.01)	(244.23)	119.72	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	172.64	(229.15)
Reduction in CRC	**-111.63**																				
Depreciation Calculations																					
Accumulated Capex Pre-Start	23,590	17.1	399.6	983.6	1,237.8	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9	1,308.9
Depreciation of Accumulated Capex	1,309	0.0	0.0	0.0	0.0	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	87.3	0.0
Post Start Capex	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Depreciation of PostStart Capex	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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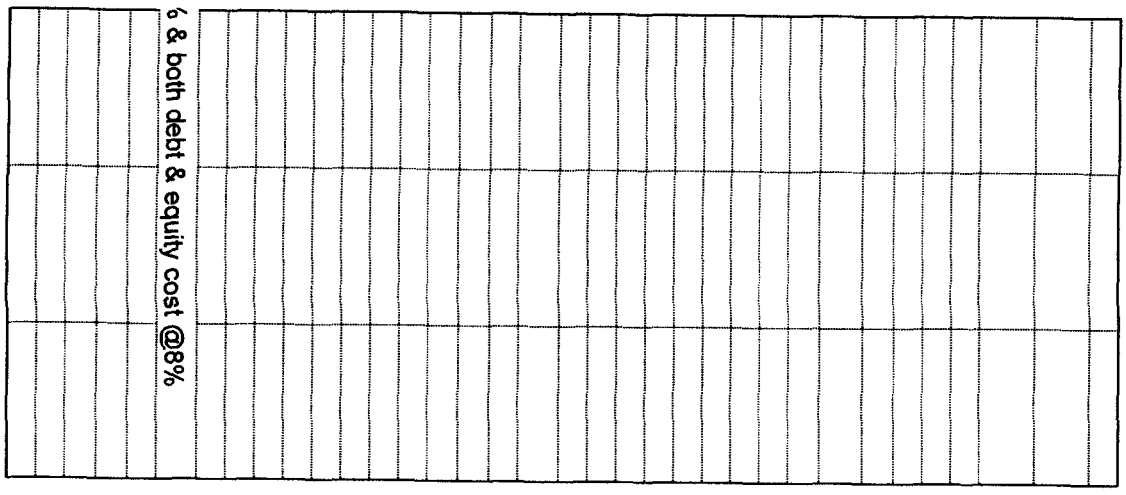
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Analysis of the 8% RoR forrmula

Impact of Capital Structure on RoR (Unlevered versus Levered return)

Pipeline Capex	404.33							
LNG Capex	1,308.88							
Total Capex	**1,713.21**							
	Asset Base	Debt:Equity	RoR	Annual return				
Equity Funding	1713.21	100%	8.00%	137.06				
Debt Funding	0.00	0%	8.00%	0.00				
Allowed Return (post tax)				137.06	8.00%	WACC		
Income Tax (allowed on return on equity)				41.12	30%	Oz tax rate		
Required Pre-tax return for 8% post tax target				**178.17**	10.40%	RoR	GTA position	
		Debt:Equity	RoR					
Equity Funding	513.96	30%	8.00%	41.12				
Debt Funding	1199.25	70%	8.00%	95.94				
Return required & Allowed Return				137.06	8.00%	WACC		
Income Tax (allowed on return on equity)				12.34	30%	Oz tax rate		
Required Pre-tax return for 8% post tax target				**149.39**	8.72%	RoR	Scenario 1 : Assuming 70%	
		Debt:Equity	RoR					
Equity Funding	685.29	40%	11.00%	75.38				

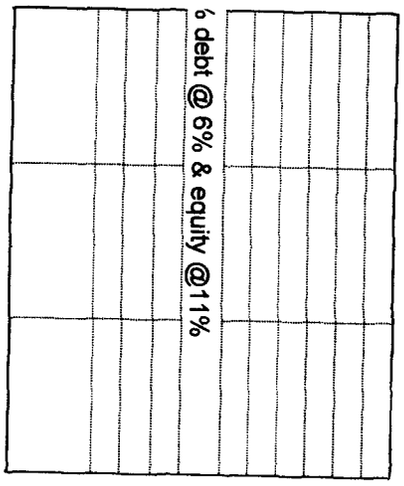
EX. J 160


% & both debt & equity cost @8%

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Debt Funding	1027.93	60%	6.00%	61.68				
Return required & Allowed Return				137.06	8.00%	WACC		
Income Tax (allowed on return on equity)				22.61	30%	Oz tax rate		
Required Pre-tax return for 8% post tax target				**159.67**	9.32%	RoR	Scenario 2 : Assuming 60%	
Conclusion: In all the above scenarios the post tax RoR is 8% but the pretax RoR required to reach the target of 8% is highest in the unlevered case where there is no debt assumed. This is because interest on debt is a tax deductible expense and it reduces the income tax component in the post tax RoR								

EX. J 162


6 debt @ 6% & equity @11%

Tariff Calculation Methodologies within the Natural Gas Supply System

1. Introduction

The operation of the RoA Gas Supply System is implemented by 2 companies: "ArmRosGasProm" CJSC and "Transgas" LLC. The first carries out import, distribution and supply of natural gas (hereafter, gas), as well as the System management. The second one implements transportation of gas from the Armenia border to the Distribution Company as well as the operation of underground storages.

The set of the Gas Supply System tariffs comprises two tariff groups:

a) Tariffs for services mutually rendered by the companies operating within the System. They are tariffs for transportation, storage, distribution and dispatch services.

b) Regulating tariffs for services rendered to gas consumers.

Tariff development procedure is implemented in a number of stages, each of which has specific goals, requires specific calculations and adoption of principles (methodology) for carrying out of those calculations.

At the first stage, the amounts of annual revenues of the System companies shall be calculated, which should be enough to incur all operating costs required for their reliable, safe and continuous operation and to gain a reasonable profit against the invested capital. It is necessary to have established principles (methodology) for calculation of the required costs and profit.

At the second stage, the cost of services rendered to customers and customer classes shall be calculated based on the classification of costs of various functions and allocation of the required revenue among the customer classes.

At the third stage, all tariff designs shall be selected and tariff rates shall be calculated.

The main objectives of the tariff methodology are:

a) to ensure financial sustainability of the System companies;

b) to attract the capital necessary for the System upgrade and expansion, at reasonable costs;

c) to stimulate provision of safe and reliable gas supply services at affordable and competitive tariffs;

d) to stimulate effective use of gas supply services by customers.

2. Determination of the Required Revenue

To ensure their continuous operation, the companies must be able to recover all reasonable costs incurred in the process of rendering services. Total revenue, which the company is allowed to receive through tariffs, is called the Revenue Requirement or Total Cost of Services.

The annual Revenue Requirement (RR) of "ArmRosGasProm" CJSC shall be calculated by the following formula:

$$AR = CPG + CGT + O\&M + D + T + R \quad (1)$$

Where:

CPG - Cost of purchased gas (without VAT);

CGT - Cost of gas transportation – annual amount, which "ArmRosGasProm" CJSC pays to "Transgas" LLC for transportation of gas throughout the Republic of Armenia.

O&M - Annual operation and maintenance costs;

D - Depreciation of fixed assets and amortization of intangible assets;

T - Taxes paid by the company (except for VAT and Profit Tax), duties and other mandatory payments established by the Legislation.

R - Allowed return.

Revenue Requirement of "Transgas" LLC shall be determined by the same formula, excluding such components as cost of purchased gas and transportation cost.

$$AR = O\&M + T + R \quad (2)$$

The Revenue Requirement of companies shall be calculated based on actual costs of the latest 12 months with some adjustments, which take into account changes in expenses and revenues already known at the moment of submission of the tariff application or to be made during the effectiveness of a new tariff, measured with reasonable accuracy.

2.1 Cost of Purchased Gas

Annual gas purchase expenses shall be determined by the following formula:

$$PGC = \sum_i C_i V_i$$

where: C_i - price of gas unit ($1000m^3$) purchased by "ArmRosGasProm" CJSC from different importers within different time-periods during the year, according to the Contracts signed and registered with the Public Services Regulatory Commission (hereafter, the Commission) in established procedures.
V_i – amount of gas purchased by "ArmRosGasProm" CJSC from different importers within different time-periods during the year.

Total amount of gas purchased during the year,

$$V = \sum_i V_i$$

necessary to ensure annual consumption, shall be determined by the following formula:

$$V = V_s + \Delta V,$$

Where:
V_s - amount of gas supplied to customers during the year.

ΔV – gas losses and gas for own needs within the gas transportation and distribution networks, calculated according to the methodology approved by the Commission.

2.2 Gas Transportation Costs

"ArmRosGasProm" CJSC, implementing gas import, distribution and sale, shall be paid for services rendered by "Transgas" LLC for gas transportation and storage, according to the tariffs established by the Commission in compliance with this Methodology, ensuring that company's Revenue Requirement calculated based on formula (2).

2.3 Operation and Maintenance Costs

Operation and maintenance costs (O&M) embrace the following groups of expenses of the Gas Supply System companies:

- Production personnel payroll, including payments to the social security fund;
- Material expenses necessary for operating;
- Repair expenses, which comprise cost of repair works carried out both by other contractors and by own personnel;
- Cost of customer service, which include meters service, meter reading, billing, payment accounting and collection costs (these costs are specific only for "ArmRosGasProm" CJSC implementing distribution and customer service functions);
- Administrative and general expenses;
- Other operating expenses, which can also comprise allowed level of bed debt expenses.

O&M expenses do not include expenses irrelevant to the licensed activity. For that kind of expenses companies shall carry out a separate accounting.

Licensees shall be obliged to carry out accounting according to the Chart of Accounts and cost assignment rules established by the Commission.

Through tariffs shall be recovered only expenses accounted in compliance with the Chart of Accounts established by the Commission.

Applying for a tariff, the company shall submit expenses for the previous year audited by an auditor, actual (forecasted) expenses for the current year and planned expenses for the settlement year.

2.4 Allowed Return

Allowed return is such an amount of profit, which allows the companies to fulfill liabilities related to capital attracted for financing of assets and not to hinder attraction of additional own or borrowed funds necessary for the development of companies.

Allowed Return shall be calculated by multiplying the regulatory asset base (Profit calculation base) (RAB) by the allowed rate-of-return (RoR).

$$AR = RAB * RoR$$

Regulatory asset base is the value of the company's net assets. It shall be calculated by the formula:

$$RAB = VFAUU - VFAPC - AD + WC$$

Where:

VFAUU - Recognized value of fixed assets that are used and useful for licensed activity approved by the Commission;

VFAPC - Value of fixed assets paid by customers but not reimbursed (for instance, value of meters or construction);

AD - Accumulated depreciation;

WC - Amount of working capital allowed by the Commission.

From time to time (but not more often than once a year) the Regulatory Asset Base shall be recalculated to take into account the following:

- Investments made in assets recognized as used and useful, without investments paid by customers;
- Allowed depreciation;
- Allowed changes in working capital.

As some investments may be done in foreign currency, the changes in exchange rates shall be taken into consideration during the recalculations, to ensure real value of the assets for regulatory purposes.

Allowed rate-of-return shall be set in the amount of weighted average capital of the company, which is the average value of the borrowed and own capital, calculated according to their weights in the capital structure.

$$RoR = \frac{\sum_i BC_i * r_i + OC * r_u}{BC + OC}$$

Where:

BC_i and r_i – are outstanding residual amount of the ith borrowing at the beginning of the settlement year and the cost of its servicing, respectively (in unit weights).
OC_i and r_u – are value of own capital at the beginning of the settlement year and its allowed (reasonable) rate of return (before tax).

2.5 Depreciation

Depreciation costs shall be calculated by the straight line method, based on historical (acquisition) cost and useful lives of used and useful fixed assets.

If fixed assets are used with low use factor or low operating hours of capacity (carrying capacity) use, the Commission shall have the right to apply reasonable reducing coefficients towards their values.

3. Cost Analysis

At the next stage of the tariff development, the analysis and allocation of companies' costs according to the licensed activities, types of costs and customer classes shall be implemented. Setting of tariffs reflecting all costs of companies for rendering services to different customers and customer classes is one of the goals of pricing. Through cost analysis the portion of various customer classes within total costs shall be determined and their allocation among the customer classes shall be carried out.

Cost analysis shall consist of the following steps:

- Functionalization of costs;
- Classification of costs;
- Definition of customer classes;
- Determination of allocation factors;
- Allocation of costs.

Methods for classification of customers, determination of allocation factors and allocation of costs shall be submitted by companies to the Commission for approval.

3.1 Functionalization of Costs

"ArmRosGasProm" CJSC has three functional areas of activity: gas import, distribution and system dispatch. "Transgas" LLC is involved in gas transportation and storage. At this step, each cost component of companies shall be divided among the aforementioned functional areas (see tables 1 and 2 of the Attachment).

3.2 Classification of Costs

Costs shall be classified into the following groups: fixed, variable and customer service.

Fixed costs are those costs that companies incur regardless of the amount of supplied gas and number of customers. They are mostly the costs associated with operation and maintenance of the company's fixed assets, and other costs that should be recovered regardless of the volume of gas consumed.

Variable costs are those costs that vary with the amount of supplied gas. These costs comprise cost of supplied gas and some other costs related to the amount of gas (i.e. bad debt write-off costs and other).

Customer service costs are those costs directly associated with the provision of services to customers. They include meter reading, billing, collection, recording and other costs, as well as costs related to the operation of meters.

Cost classification is presented in Attachments No.No. 3 and 4.

3.3 Definition of Customer Classes

According to the RoA Energy Law, differentiation of tariffs can be done based on the required capacity, consumption amount, time and connection terms. The differentiation shall be made based on customers classes. Each customer class shall comprise customers of the same consumption characteristics, whose gas supply and servicing results in the more or less similar price load for the system.

During the customer classification, except for the technical characteristics, economic characteristics also can be taken into account, such as the value of service, price flexibility, availability of an alternative, competitive service.

From the abovementioned, the following classes of customers shall be recommended:

1. Population (residential customers). This class embraces those customers, who use natural gas for residential purposes.

2. General Commercial Customers. This class consists of all those customers, who do not use natural gas for residential purposes and, are not included into the next four classes.

3. Compressed Natural Gas Suppliers. This class comprises customers supplying compressed natural gas for vehicles.

4. Thermal Power Plants.

5. Heat Supply. This class includes boiler houses producing thermal energy for sale.

6. Large industrial customers.

The above customer groups refer only to ArmRosGasProm CJSC involved in distribution.

Customer classes and their structure shall be approved by the Commission upon submission by the company.

For TransGas Ltd., consumers are represented by the distribution company and those consumers that import gas for ancillary needs and use transportation and storage services.

3.4. Allocation of Costs

The costs classified in the next stage of the analysis are allocated among customer groups. Such allocation is carried out by means of allocation factors to be determined in a manner to reflect the causes of costs incurred within customers groups with maximum accuracy.

Allocation of the fixed costs is carried out proportionally to the value of the own peak consumption for individual customer groups, regardless of when such consumption occurs. This method of allocation is called the Non-coincidental Peak (NCP) as opposed to the method called the Coincident Peak (CP), when allocation is carried out proportionally to the consumption of individual customer groups at the moment of the maximum system peak.

The allocation factors are determined through the following formula:

$$K_{Ni} = \frac{N_i}{\sum_i N_i}$$

where:

K_{Ni} - is the allocation factor of the ith customer group of the fixed costs;

N_i - is the maximum daily consumption of the ith customer group.

Allocation of the variable costs is carried out proportionally to the annual consumption value of the customer groups:

$$K_{Vi} = \frac{V_i}{\sum_i V_i}$$

where:

K_{Vi} - is the allocation factor of the ith customer group of the variable costs;

V_i - is the annual consumption of the ith customer group.

Allocation of customer service costs is carried out proportionally to the number of customers 'reduced' in the customer groups. Taking into consideration the fact that servicing customers in different customer groups incurs different costs within the company, and assuming one residential consumer as a unit, for the consumers of the rest of the customer groups we apply 'reduction' factor, which reflect such differences to this or that extent.

With consideration of the above, the allocation factors of customer service costs will be determined through the following formula:

$$K_{ni} = \frac{\alpha_i n_i}{\sum_i \alpha_i n_i}$$

where:

n_i - is the number of customers in the ith customer group;

α_i - is the 'reduction' factor of one customer of the ith customer group to a residential consumer, showing what is approximately the number of residential consumers the service costs of which are equivalent to the average service costs of one customer of the given group.

Allocation of the classified costs is carried out on the basis of the determined allocation factors through the following formulas:

$C_{Ni} = K_{Ni} * C_N$;

$C_{Vi} = K_{Vi} * C_V$;

$C_{ni} = K_{ni} * C_n$

where:

C_N, C_V and C_n - are respectively the fixed, variable and customer service costs in the system;

C_N, C_{Vi} and C_{ni} - are the portion of the corresponding costs reimbursed by the ith customer group.

4. Selection of Forms and Structure and Calculation of Gas Supply Sector Tariffs

4.1. Transportation Tariff

Transportation tariff is established by the TransGas Ltd. for gas transportation and storage services. The company renders services to ArmRosGasProm by transporting the gas imported by the latter from the border to the separation point with the distributor. Similar services will be rendered to other Licensees importing gas for ancillary needs or for export.

In the absence of compressed air plants, the costs necessary to operate the transportation system do not depend upon the amount of transported gas and are considered fixed – capacity costs. Part of the costs associated with gas storage can be considered directly proportional to the amount of the stored gas (for instance, the cost of gas spent on compressed air plant operation or the financial costs associated with the stored gas). However, since the transporter is not the gas owner, these costs will be recovered from the expenses of the gas owners and will not be included in the revenue requirement of the transporter.

Gas transportation tariff is a one-part tariff, the service measurement unit for which may be:

a) maximum daily consumption of the busiest month in conditions of transportation system capacity restrictions (thousand cubic meters per day);

b) a unit of transported gas amount (thousand cubic meters) in the absence of transportation system capacity restrictions;

In instance (a), transportation tariff will be determined through the following formula:

$$T_t = \frac{RR_t}{12\sum_i Q_{i\max}} \text{ (AMD/month thousand cubic meters/per day)}$$

where:

$Q_{i\max}$ - is the maximum daily consumption (thousand cubic meters per day) of the busiest month for the ith gas transportation client.

The monthly payments of gas transportation clients are fixed values equal to:

$$MP_{ti} = T_t * Q_{i\max}$$

and are not dependent on the volume of transported gas during the given month.

Maximum daily gas consumption is determined by means of the measurements carried out through the client's meter in advance. If no such measurements are taken, the maximum daily gas consumption may be determined by means of dividing the monthly consumption of the busiest winter month by the number of days in the month. If there are no such data either, then the maximum consumption shall be determined by the capacity of the consumption restriction equipment.

In instance (b) transportation tariff is determined through the following formula:

$$T_t = \frac{RR_t}{\sum_i V_{ti}^{year}} \text{ (AMD/thousand cubic meters)}$$

where:

V_{ti}^{year} - is the amount of transported gas for the ith Licensee during the year (thousand cubic meters), measured at the delivery points to the client or distributor from the transportation system. Monthly gas transportation charge will be:

$$MP_{ti} = T_t * V_{ti}^{mon}$$

where:

V_{ti}^{mon} - is the amount of gas transported during the given month for the ith customer determined through meter readings, if the gas delivery to the owner is carried out directly from the transportation system and in accordance with the following formula:

$$V_{ti}^{mon} = \frac{V_{di}^{mon}}{1 - \frac{\alpha_d}{100}}$$

provided that the delivery is carried out through the distribution system. In this formula α_d indicates the gas losses within the distribution system expressed in percentage to the gas entering the distribution system.

*4.2. **Distribution Tariff***

Distribution tariffs shall be applied to the Licensees (client), which import gas for own consumption or for export (when gas is transported trough the distribution system also).

Gas distribution tariff is a one-part tariff, for which the service measurement unit may be:

a) Maximum daily consumption of the busiest month in conditions of the distribution system capacity restriction (thousand cubic meters per day).

b) A unit of gas transported through the distribution system in the absence of the distribution system capacity restrictions (thousand cubic meters).

In instance (a), distribution tariff will be determined through the following formula:

$$T_t = \frac{RR_d}{12\sum_i Q_{i\max}} \text{(AMD/month thousand cubic meters/per day)}$$

where:

$Q_{i\max}$ - is the ith client's maximum daily consumption (thousand cubic meters per day) of gas transported through the distribution system, within the busiest month.

The monthly payments are fixed values equal to:

$$MP_{di} = T_d * Q_{i\max}$$

and are not dependent on the volume of gas transported through the distribution system during the given month.

Maximum daily gas consumption is determined by means of the measurements carried out through the client's meter in advance. If no such measurements are taken, the maximum daily gas consumption may be determined by means of dividing the monthly consumption of the busiest winter month by the number of days in the month. If there are no such data either, then the maximum consumption shall be determined by the capacity of the consumption restriction equipment.

In instance (b) distribution tariff is determined through the following formula:

$$T_d = \frac{RR_d}{\sum_i V_{di}^{year}} \text{(AMD/thousand cubic meters)}$$

where:

V_{di}^{year} - is the amount of gas transported through the distribution system for the i[th] Licensee during the year (thousand cubic meters), measured at the delivery points to the client from the distribution system.

Monthly gas distribution charge will be:

$$MP_{di} = T_d * V_{di}^{mon}$$

where:

V_{di}^{mon} - is the amount of gas transported through the distribution system for the i[th] customer during the given month, which is determined through meter readings.

4.3. ***Tariffs for Dispatching***

Tariffs for dispatching shall be applied to the Licensees, which import gas for own consumption or for export.

Tariff for dispatching is determined as follows:

$$T_d = \frac{NR_d}{\sum_i V_{imp.i}^{year}}$$

where:

RR_d - portion of the dispatch service in the revenue requirement of "ArmRosGasProm" CJSC, for which separated calculation is needed.

$\sum_i V_{imp.i}^{year}$ - amount of gas imported during a year by different Licensees, including "ArmRosGasProm" CJSC.

Importers shall pay "ArmRosGasProm" CJSC for the dispatch services, since the dispatch service is within its structure. The portion of monthly payment shall be determined by the following formula:

$$MP_{di} = \frac{T_d \cdot V_i^{month}}{\left(1 - \frac{a_y}{100}\right) \cdot \left(1 - \frac{a_t}{100}\right)}$$

where:

V_i^{month} - amount of gas accepted at the separation points during the given month by the Licensee.

a_t and a_d - gas losses expressed in percentage in the transportation and distribution systems in compliance with the amount of gas entered to the system.

In the event natural gas owned by the Licensee is not entered to the distribution system, then a_d is accepted to be equal to zero.

4.4. ***Retail Tariffs of the Customer Classes***

Calculation basis for tariffs of customer classes is considered to be expenses incurred by the distribution company ("ArmRosGasProm" CJSC) classified and allocated between the customer classes.

Tariff rates are calculated within the one-part tariff or two-part tariff system. Moreover, other approaches to the tariff structure and tariff rate calculation can be offered by the company.

Below is the recommended tariff structure and tariff rate calculation of the aforementioned customer classes.

The rate of the purchased gas price, separated from the service rate, is established in all tariffs. In case of the change of the purchased gas price or exchange rate differences, the rate of the purchased gas price can be altered without making application to change the entire tariff.

Tariff rate of the purchased gas price is general for all customer classes and shall be calculated in accordance with the following formula:

$$TR_g = \frac{\bar{c}}{\left(1-\frac{a_y}{100}\right)\cdot\left(1-\frac{a_t}{100}\right)}$$

where:

$\bar{c}$ - is weighted average cost of the gas unit purchased for internal consumption during the reporting period, which is equal to:

$$\bar{c} = \frac{\sum_i c_i V_i}{\sum_i V_i}$$

4.4.1. ***Population (residential customers)***

Tariffs for gas supplied to the population shall consist of the following components:

a) Gas price rate (TR_g) expressed at AMD/cubic meter;
b) Monthly fixed customer charge, which is expressed at AMD/customer/month and shall be determined based on the following formula:

$$CC_d = \frac{E_{Nd} + E_{nd}}{12 * n_d}$$

where:

E_{Nc} and E_{nc} – portions of fixed costs and service costs of the residential customers.

n_c - average annual number of residential customers.

Monthly charge for the residential customer will be:

$$MP_d = V_m * TR_g + CC_d$$

where:

V_m –monthly gas consumption in cubic meter.

4.4.2. ***General Commercial Customers***

The following tariff rates shall be applied to this class:

a) Gas price rate;
b) Gas transportation and distribution service rate expressed at AMD/cubic meter, which shall be determined as follows:

$$TR_{N.gc} = \frac{E_{Ngc}}{V_{gc}^{year}}$$

where:

E_{Ngc} – portion of fixed costs of the general commercial class;

V_{gc}^{year} - annual gas consumption of general commercial customer class.

c) Monthly fixed customer charge expressed at AMD/customer/month and is determined as follows:

$$CC_{gmonth} = \frac{E_{ngmonth}}{n_{gmonth}}$$

where:

E_{ngc} – portion of service costs of the consumers pertaining to the general commercial customer class;
n_{gc} – number of the customers of the group.

Monthly payment for this class shall be determined as follows:

$$MP_{gc} = V_m \left(TR_g + TR_{Ngm}\right) + CC_{gm}.$$

4.4.3. ***Compressed Natural Gas Suppliers and District Heating Companies***

Tariff structure of these classes is similar to the previous class, and tariff rates shall be determined by using portions, consumption volumes and number of customers of the corresponding expenses of the classes.

4.4.4. ***Thermal Power Plants***

The following tariff rates shall be applied for thermal power plants:

a) Monthly fixed charge for daily gas maximum consumption; (AMD/month/[thousand cubic meter/day]), which is determined by the following formula:

$$TR_N = \frac{E_{Ntpp} + E_{ntpp}}{12 Q_{tpp\,max}}$$

where:

E_{Ntpp} and $E_{ntpp.}$ – are portions of fixed and service costs of the thermal power plants class;

$Q_{tpp..max}$ – is maximum daily consumption of the companies of the class (thousand cubic meters/per day).

Monthly charge shall be determined by the following formula:

$$MC_{tpp} = V_{tpp} * TR_g + Q_{tpp} * TR_N$$

where:

$V_{tpp.}$ – is the monthly gas consumption of the given thermal power plant (thousand cubic meter)

Q_{tpp} – is maximum daily consumption of the given thermal power plant during the reporting year.

4.4.5. ***Large Volume Industrial Customers***

Tariff structure of this class is the same as the previous one. Tariff rates shall be determined by the same formulas using share portions of the costs allocated to this class and amounts of daily gas maximum consumption.

The structure of proposed tariffs may be implemented by stages, depending on availability of the required information.

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TDA / TBUCA Regulations Interpretive Guidelines

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INTRODUCTION AND OVERVIEW

Scope of the Interpretive Guidelines

The materials in the Guidelines deal with the ways in which the Timor-Leste Tax Administration applies the income tax system to transactions in the areas of oil, gas and minerals. The focus is the simplification, through examples and explanatory comments, of the key provisions of the Regulations issued pursuant to the Taxes and Duties Act (2008) "TDA" and the Taxation of Bayu-Undan Contractors Act (2003) "TBUCA."
The objective is to provide some understanding in respect of the key provisions of the Regulations and also establish consistent interpretation and application module between similar provisions of the TDA and TBUCA.

Timor-Leste taxation laws governing oil, gas and mineral resources are complicated. There are a number of factors contributing to its complexity. The source of the laws is one factor. A substantial part of the laws governing taxation in the Bayu-Undan portion of the Joint Production Development Area (JPDA) is the inherited Indonesian Tax Law. Procedural laws are also sourced and codified in different mediums. Up until now, there are no interpretative Regulations to expand on the substantive provisions of the applicable taxation laws in Timor-Leste. During the UN Administration in Timor-Leste, there was a seemingly constant change in the taxation laws, and sometimes with unresolved ambiguities. Furthermore, the taxation laws governing hydrocarbons is probably one of the most complex branches of taxation laws.

A substantial number of the oil and gas taxpayers in Timor-Leste are foreign entities. International trade and investment transactions are themselves often very complicated, and the complications are compounded by sometimes conflicting demands of two or more national tax regimes.

These Guidelines are designed to serve as an initial step in the process of simplifying the applicable tax laws regulating the hydrocarbon industry in Timor-Leste-the determination and administration of Timor-Leste tax liabilities resulting from the conduct of related oil and gas business.

The overriding mission of the National Directorate of Petroleum and Mineral Revenue (NDPMR) is to provide Timor-Leste oil, gas and mineral taxpayers top quality service by helping them to understand and meet their tax obligations and by applying the tax law with integrity and fairness to all. It is the duty of NDPRM to correctly apply related Timor-Leste tax laws and regulations, determine the reasonable meaning of various oil, gas and mineral tax provisions in light of the underlying intent[1].

At the center of a sound tax administration is the correct interpretation of the applicable tax laws and regulations. The State revenue accruing from oil, gas and mineral resources is properly protected only by ascertaining and applying the proper interpretation of the applicable laws and the regulations made thereunder.

[1] See-Articles 14(i), 15(a) through (c) of the Organic Statute of the Ministry of Finance, issued pursuant to Decree-Law no. 13/2009.

NDPRM's intent in providing this published interpretive guideline is to serve Timor-Leste taxpayers fairly and with integrity by providing correct and impartial interpretation of the applicable tax laws. The interpretive guidelines will also provide taxpayers with reasonable certainty by providing a window into the "mind" of the Timor-Leste Tax Administration.

Hydrocarbon deposits on the ground are endowments from nature. They are exhaustible and finite. It is only by converting some of their value to financial assets for the society and the investors and managing the revenue properly can the resources make any meaningful contribution to economic development. The establishment of an appropriate fiscal policy is a key factor and a precondition for good results.

A good fiscal regime is important for economic development. When a country exploits its petroleum and or mineral resources for financial assets, appropriate taxation is even more crucial because the production of oil, gas and minerals ordinarily give rise to economic/resource rent.

Certainty in the application of taxation laws is a prerequisite of a sound tax administration. The narratives and the examples provided in the present guidelines is another step taken by the NDPRM to assist taxpayers in understanding key provisions of Chapter IX of the Taxes and Duties Act (2008) and the Taxation of Bayu-Undan Contractors Act (Law No. 3/2003), and more particularly the regulations issued thereunder.

The substantive provisions of Chapter IX of the Taxes & Duties Act (TDA) mirror substantially the provisions of the Taxation of Bayu Undan Contractors Act (TBUCA), and as such, the discussions and the examples in the Interpretive Guidelines are similar. The only ***material*** difference between the two substantive laws is the nexus and interplay between the TBUCA and the relevant Indonesian taxation laws and procedures. Those Indonesian laws and procedures are not relevant and inapplicable in the areas subject to the TDA and the Regulation TDA-IX/12.

Users to are advised to pay particular attention to the fact that the relevant Indonesian laws and procedures bear a great degree of relevancy in the portion of the Joint Production Development Area subject to the TBUCA as well as the area designated as the Greater Sunrise.

Finally, users of these present Guidelines, like any other interpretive guidelines, must understand that interpretive guidelines are like "work-in-progress" and ever evolving. New facts and circumstances may compel the Timor-Leste Tax Administration to adopt a different approach to a particular provision of the law and or the Regulations now or in the future.

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Regulation TDA-IX/12: Interpretive Guidelines

Section 3
Scope of Regulations

The Taxes and Duties Act ("TDA") was passed by the Timor-Leste Parliament on 25th June 2008, with effect retroactively from 1st January 2008 for annual taxes and 1st July 2008 for all other taxes. The TDA applies to the exclusive territory of Timor-Leste including the Joint Production Development Area (JPDA), **except for the Bayu-Undan and the Greater Sunrise parts of the JPDA**.

UNTAET Regulation 2000/18 was essentially repealed by the TDA, and a single framework of taxation in Timor-Leste resulted (but subject to the Timor Sea Treaty, where applicable). However, the TDA did not abolish the regime governing the collection and recovery of tax, tax offences and sanctions, as those matters will still be governed by UNTAET 2000/18 until the passage of new laws covering such matters[2]. Chapter IX of the TDA applies exclusively to persons whose business pertains to the oil and gas industry and carrying on business within the Timor-Leste exclusive area and the Kitan portion of the JPDA.

Chapter IX (TDA) Regulations[3] were issued in July 2012 and was effective for the 2011 tax year. Section 3 (ambit of the Act) of the TDA excludes the application of all the provisions of the law except those contained in Chapter IX to the oil and gas industry. There were no provisions governing the computation of taxable income in Chapter IX of the TDA because of the exclusion contained in Section 3 of the TDA. Regulation TDA-12/2012 now governs the computation of taxable income and other matters relating to the administration of tax in relation to the oil and gas business in areas subject to Chapter IX of the TDA.

[2] See-Sections 93, 93.4 and 93.5 of the UNTAET Regulation 2000/18
[3] Regulation TDA-IX/2012

The chart below summarizes the oil and gas taxation regime in Timor-Leste

	Timor-Leste Exclusive Area	**JPDA**	
	Onshore & Offshore within Timor-Leste exclusive territorial waters	JPDA (**Non-Annex F**)	JPDA (**Annex F**)
Tax law applicable	TDA (including Chapter IX- for oil & gas business), Regulation TDA-IX/2012 and the UNTAET Regulation 2000/18.	Chapter IX of the TDA, Regulation TDA-IX/2012, Timor Sea Treaty, including Annex G, Indonesian Law on Value Added Tax on Goods and Services and the UNTAET Regulation 2000/18.	Indonesian Law on Income Tax, Indonesian Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods, Indonesian Law on General Procedure (as modified by UNTAET Regulation 2000/18, Timor Sea Treaty, including Annex G, UNTAET Regulation 2000/18, Taxation of Bayu-Undan Contractors Act (TBUCA) , Tax Stability Act and TBUCA Regulations (when issued).
Comments	The TDA provides the framework for general taxation regime in Timor-Leste exclusive area. UNTAET Regulation 2000/18 and Regulation TDA-IX/2012 govern tax administration.	The TDA repeals the previous Petroleum Tax Act Regulation TDA-IX/12 and UNTAET/2000/18 govern tax administration. Consistent with the sharing formula under the Timor Sea Treaty, 90% of the revenue is subject to Timor-Leste taxation.	The Timor Sea Treaty (including Annex G) applies. Consistent with the sharing formula under the Timor Sea Treaty, 90% of the revenue is subject to Timor-Leste taxation. The TBUCA Regulation issued pursuant to Section 16 of TBUCA is yet to be signed and published by the Minister of Finance.

The TDA Regulations are applicable only to a Contractor or Subcontractor, and any person receiving an amount for goods or services supplied to a Contractor or Subcontractor or by a Contractor or Subcontractor to any person in connection with Petroleum Operations in Timor- Leste, excluding the area designated as Annex f in the Timor Sea Treaty.

The diagram below shows the applicability of TDA. The operative words are "Petroleum Operations." Section 68 of the TDA defines the phrase to "Petroleum Operations" to mean:

"**authorised activities under a Petroleum Agreement".**

Petroleum Agreement is defined under Section 68 to mean:

(a) A contract, licence, permit, or other authorisation in relation to petroleum operations made or given pursuant to the Timor-Leste Petroleum Act, except for a Seepage Use Authorisation; or
(b) An authorisation or production sharing contract made under the Code;

NDPRM has interpreted[4] the phrase "Petroleum Operations" in different but relevant circumstances to mean virtually anything excepting the business of the taxpayers that is only *tangentially* connected with activities "authorized under a Petroleum Agreement."

Example 1 (Scope of TDA Regulations)

Company X is a sub-Contractor providing drilling services to a Contractor T which is operating in the Kitan field. In addition, Company X also leases construction machinery to a Timor-Leste construction Company W (unrelated to the Contractor T doing business in the Kitan field), and such construction company W is not engaged in any activity in the Kitan field or working on any project related to the Kitan field. Therefore, while Company X's income derived from its drilling services to Contractor T is subject to taxation under the TDA Regulations, its leasing income derived from the leasing of construction machinery to Company W is not subject to taxation under the TDA Regulations. Company X should refer to other tax regulations and tax regimes of Timor-Leste to determine the taxability of the leasing income derived from the leasing of construction machinery to Company W.

Section 5.1

Sources of Income

Section 5.1 of the TDA Regulations describes the types of income subject to taxation under the TDA Regulations, with the following definition of "Timor-Leste source income":

[4] Public Ruling 2010/81.

An amount is Timor-Leste-source income to the extent to which the amount is connected with the performance of petroleum operations or project:

(a) income from petroleum operations or project carried on by a Contractor or Subcontractor resident in Timor-Leste; or

(b) by a non-resident through a permanent establishment in Timor-Leste as determined under the present Regulation and any other applicable tax laws;

(c) income from the alienation of any movable property of a Contractor used in deriving Timor-Leste-source income referred to in subparagraphs (a) and (b);

(d) income from the lease of immovable property in Timor-Leste whether improved or not, or from any other interest in or over immovable property, including the right to explore for, or exploit, natural resources, in Timor-Leste;

(e) income from the alienation of any property or right referred to in paragraph (d) or from the alienation of any ownership interest in a legal person the assets of which consist wholly or principally of property or rights referred to in paragraph (d);

(f) dividend paid by a resident or permanent establishment;

(g) interest, royalties, management fees, annuity, or any other income paid by a resident or borne by a permanent establishment in Timor-Leste of a non-resident;

(h) income from services rendered in Timor-Leste relating to construction, building activities, construction consulting services, air or sea transportation, mining and mining consulting services, insofar as the remuneration is paid by a resident person or borne by a Timor-Leste permanent establishment of a non-resident person; and

(i) notwithstanding paragraphs (a)-(h), an amount taxable in Timor-Leste under an international agreement or Treaty.

What is important to bear in mind is that 5.1 must be interpreted in conjunction with the definition of the scope of the TDA Regulations, as stated in Section 3 (Scope of Regulations). Under Section 3 of the TDA Regulations, the areas of Timor-Leste which are defined to be within the scope of the TDA Regulations are defined, and just as importantly, the areas which are

excluded from the TDA Regulations (such as the area to be governed by the TBUCA Regulations) are also specified.

Income with a Timor-Leste Source by reason of a Permanent Establishment

In defining what is considered as Timor-Leste "source of income", Section 5.1 also refers to the concept of "permanent establishment" ("PE"). Later on, in Section 6, the concept of how taxable income is determined and the extent certain types of income is "attributed" to the PE is addressed, but without further explanation of the meaning of a PE. Therefore, we will discuss the concept of a "permanent establishment" as far as the Timor-Leste tax administration is concerned in this section.

Permanent establishment, abbreviated as "PE", is a commonly used prevalent concept in the field of international taxation, in many countries. PE is also a concept adopted in almost all income tax treaties to determine the taxability of business profits of a non-resident enterprise (that is, a company or business which is the tax resident of one contracting country/state , doing business in another contracting country/state). It is also the concept officially adopted by the OECD (Organisation for Economic and Cooperation for Developed Countries), and also by the United Nations in its model tax convention. In contrast to the OECD model, the United Nations model is more geared towards developing countries, as opposed to developed countries[5]. In explaining what is a PE for purposes of Timor-Leste tax laws, it is therefore helpful to refer to the PE definitions of these two model conventions.

Most treaties provide that business profits (sometimes defined in the treaty) of a resident of one country are subject to tax in the other country only if the profits arise through a permanent establishment in the other country. Many treaties, however, address certain types of business

[5] The Timor-Leste treaty with Portugal, which has been signed in 2011 and which has been ratified, is closer to the United Nations model in its definition of a permanent establishment

profits (such as directors' fees or income from the activities of athletes and entertainers) separately. Such treaties also define what constitutes a permanent establishment (PE). Most but not all tax treaties follow the definition of PE in the OECD Model Treaty. Under the OECD definition, a PE is a fixed place of business through which the business of an enterprise is carried on. Certain locations are specifically enumerated as examples of PEs, including branches, offices, workshops, and others. Specific exceptions from the definition of PE are also provided, such as a site where only preliminary or ancillary activities (such as warehousing of inventory, purchasing of goods, or collection of information) are conducted.

While in general tax treaties do not specify a period of time for which business activities must be conducted through a location before it gives rise to a PE, most OECD member countries do not find a PE in cases in which a place of business exists for less than six months, absent special circumstances. Many treaties explicitly provide a longer threshold, commonly one year or more, for which a construction site must exist before it gives rise to a permanent establishment. In addition, some treaties, most commonly those in which at least one party is a developing country, contain provisions which deem a PE to exist if certain activities (such as services) are conducted for certain periods of time, even where a PE would not otherwise exist.

Even where a resident of one country does not conduct its business activities in another country through a fixed place or business, a PE may still be found to exist in that other country where the business is carried out through a person in that other country that has the authority to conclude contracts on behalf of the resident of the first country. Thus, a resident of one country cannot avoid being treated as having a PE by acting through a dependent agent rather than conducting its business directly. However, carrying on business through an independent agent will generally not result in a PE.

Under the OECD model tax convention, PE is defined as: "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and then it goes on to indicate that PE includes especially:

a) a place of management;
b) a branch;

c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

A building site or construction or installation project
if it lasts more than twelve months.

Then, the OECD model tax convention **specifically excludes** the definition of a PE from the following:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person -- other than an agent of an independent status to whom paragraph 6 applies -- is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in

that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

In comparison, the United Nations model tax convention has the following definition of what is a PE (Article 5):

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) A place of management;

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

(f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" also encompasses:

(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person-- other than an agent of an independent status to whom paragraph 7 applies--is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in

that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

As can be seen, the definitions of a PE under the United Nations model tax convention and the OECD 2010 model tax convention are quite similar.

Pursuant to Section 4 of the Regulation TDA-IX/12, a "**Permanent Establishment**" means:

(a) a place of management;
(b) a branch;
(c) a representative office;
(d) an office;
(e) a factory;
(f) a workshop;
(g) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources, including any place of drilling for mineral exploration;
(h) a fishery, place where animal husbandry is conducted, farm, plantation, or forest'
(i) a construction, installation, or assembly project;
(j) the furnishing of services through employees or other personnel, if conducted for more than sixty days in any 12-month period;
(k) a natural legal person acting as a dependent agent; or
(l) an agent or employee of a non-resident insurance company, if the agent or employee collects premium, or insures risks, in Timor-Leste;

As can be seen, the above working definition of "permanent establishment" under the TDA Regulation is substantially similar in many respects to the OECD model and the United Nations model, but with certain material differences in certain respects.

In understanding the use of the PE concept in the context of Timor Leste taxation, and in particular for purposes of the TDA Regulations, it is important to note that the "permanent establishment" concept is not necessarily the only concept or term being used in describing the criteria for taxation by a taxing jurisdiction around the world. Other terminology being used include: "taxable nexus", "engaged in a trade or business", "taxable presence".

For example, in the Federal tax laws of the United States, a common law jurisdiction, the term "permanent establishment" is not used at all in describing the conditions which would result in a non-resident taxpayer being subject to U.S. income taxation for certain activities, in a manner similar to the way U.S. residents are taxed (that is, subject to progressive tax rates, and being allowed to take deductions against the income, etc.). However, taken as a whole, the criteria

used in many such jurisdictions, while the term "permanent establishment" is not specifically mentioned in their national tax law, are essentially equivalent to that of a permanent establishment.

Another concept which is necessary for the effective application of the permanent establishment concept is concept of "attribution" of income. Just because a non-resident company may have a permanent establishment in Timor-Leste, does not mean all its income has a source in Timor-Leste. This concept will be discussed later under Section 6.

Example 2 (Illustration of the Source of Income concept)

Using the same basic facts as in Example 1 above, Company X, in addition to the drilling services provided to Contractor T, it performs through a permanent establishment in Timor-Leste, it also performs engineering design services to Contractor T, through work done outside of Timor-Leste, in its home country office in Singapore. Therefore, Company X's income derived from the engineering design services performed in Singapore are not attributable to its PE in Timor-Leste, and is not sourced in Timor-Leste by because of its PE. On the other hand, it may nevertheless be Timor-Leste source income due to a different reason. If Contractor T is paying Company X for the engineering services in connection with a PSC, Contractor T may have a withholding obligation to withhold tax on such payments to Company X (that is, withholding tax at a flat rate against the gross amount of income derived from the engineering design services. In other words, Company X may have two types income taxed differently under the TDA Regulations: (i) income from the drilling services as income derived through a PE, and subject to a 30% on the net taxable income (gross income less allowable expenses as deductions against taxable income), such that this income is defined as Timor-Leste source under Section 5.1 category (b), and (ii) income from the engineering design services, subject to a withholding tax on the gross receipts (i.e. flat rate imposed on the gross income, without the allowance of any deductions), which while not Timor-Leste source income as defined under the TDA Regulations, is nevertheless subject to withholding tax.

Income with a Timor-Leste Source by reason of a Tax Treaty

Under the TDA Regulations Section 5.1 (i), it is provided that: "notwithstanding paragraphs (a)-(h), an amount taxable in Timor-Leste under an international agreement or Treaty" will be included into the definition of Timor-Leste source income. It should be noted that as of the date of the preparation of these guidelines, other than the Timor Sea Treaty between Australia and Timor-Leste, there is only one other income tax treaty that Timor-Leste has signed with another tax jurisdiction (CONVENTION BETWEEN THE PORTUGUESE REPUBLIC AND THE DEMOCRATIC REPUBLIC OF TIMOR-LESTE FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, signed September 27, 2011, and which has been ratified). It is probable that there will be more tax treaties negotiated and entered into by Timor-Leste.

In the context of income tax treaties, many countries have agreed with other countries in treaties to mitigate the effects of double taxation (Double Tax Avoidance Agreement). Tax treaties may cover income taxes, inheritance taxes, value added taxes, or other taxes. Besides bilateral treaties, also multilateral countries are in place: Countries of the European Union (EU) have also entered into a multilateral agreement with respect to value added taxes under auspices of the EU, while a joint treaty of the Council of Europe and the OECD exists open to all nations. Tax treaties tend to reduce taxes of one treaty country for residents of the other treaty country in order to reduce double taxation of the same income. The provisions and goals vary highly; very few tax treaties are alike.

Generally, tax treaties, including the one which Timor-Leste has entered into with Portugal, perform the following functions

- define which taxes are covered and who is a resident and eligible for benefits,
- reduce the amounts of tax withheld from interest, dividends, and royalties paid by a resident of one country to residents of the other country,
- limit tax of one country on business income of a resident of the other country to that income from a permanent establishment in the first country,
- define circumstances in which income of individuals resident in one country will be taxed in the other country, including salary, self-employment, pension, and other income,
- provide for exemption of certain types of organizations or individuals, and

- provide procedural frameworks for enforcement and dispute resolution.

The stated goals for entering into a treaty often include reduction of double taxation, eliminating tax evasion, and encouraging cross-border trade efficiency. It is generally accepted that tax treaties improve certainty for taxpayers and tax authorities in their international dealings.

Several governments and organizations have proposed model treaties to use as starting points in their own negotiations. The Organisation for Economic Co-operation and Development (OECD) model treaty is often used as such a starting point. The OECD members have from time to time agreed on various provisions of the model treaty, and the official commentary and member comments thereon serve as a guidance as to interpretation by each member country. Similarly, the United Nations has a model income tax convention prototype which it has suggested for use by developing countries.

In general, the benefits of tax treaties are available only to persons who are residents of one of the treaty countries. In most cases, a resident of a country is any person that is subject to tax under the domestic laws of that country by reason of domicile, residence, place of incorporation, or similar criteria.

Generally, individuals are considered resident under a tax treaty and subject to taxation where they maintain their primary place of abode. However, residence for treaty purposes extends well beyond the narrow scope of primary place of abode. For example, many countries also treat persons spending more than a fixed number of days in the country as residents.[9] The United States includes citizens and green card holders, wherever living, as subject to taxation, and therefore as residents for tax treaty purposes. Because residence is defined so broadly, most treaties recognize that a person could meet the definition of residence in more than one jurisdiction (i.e., "dual residence") and provide a “tie breaker” clause. Such clauses typically have a hierarchy of three to five tests for resolving multiple residency, typically including permanent abode as a major factor. Tax residency rarely impacts citizenship or permanent resident status, though certain residency statuses under a country's immigration law may influence tax residency.

Entities may be considered resident based on their country of seat of management, their country of organization, or other factors. The criteria are often specified in a treaty, which may enhance or override local law. It is possible under most treaties for an entity to be resident in both countries, particularly where a treaty is between two countries that use different standards for residence under their domestic law. Some treaties provide "tie breaker" rules for entity residency, some do not. Residency is irrelevant in the case of some entities and/or types of income, as members of the entity rather than the entity are subject to tax

In the context of the TDA Regulations, the position of the Timor-Leste tax administration is that a non-resident who does not have the type of income as described in Section 5.5 (a), (c), (d), (e), (f), (h) or (i), but is nevertheless deriving income from operating through a permanent establishment, will be deemed to have Timor-Leste source income.

Two other concepts are worth mentioning on the subject of "Applicable Laws" of the TDA Regulations. While the TDA Regulations may provide specific regulations as interpretation of the substantive TDA tax law, taxpayers should expect that the tax administration of Timor-Leste will take the approach which will most effectively enforce its tax laws and regulations and consequently prevent tax evasion. For example, where and when it is warranted, the tax administration may recognize substance over form, if it is discovered that the formal arrangements of the taxpayer(s) are in fact artificial and have no economic substance, and that the adoption of such formal arrangements is merely an attempt to frustrate the purpose of the Timor-Leste laws.

By extension, the corporate law doctrine of "lifting the veil" may equally be extended to tax arrangements between related taxpayers where necessary to prevent the circumvention of the applicable Timor-Leste tax laws. Both principles have been applied in the past by the Timor-Leste tax administration to matters connected with capital gains under Article 11 (Alienation of property) of Annex G to the Timor Sea Treaty and in cases of transfer pricing arrangements between related parties.

Section 6

Permanent Establishments

While the previous section (that is, Section 5.1) is concerned with the definition of what is a "permanent establishment" ("PE") (determining whether a PE exists or not), Section 6 addresses the issues of attribution of income to a PE, and what income attributable to a PE is taxable for Timor-Leste income taxation purposes, after the existence of a PE has been established.

Section 6
Permanent Establishments
Section 6 of the TDA Regulations provide the following with respect to income of a PE:
"The taxable income of a non-resident carrying on business activities in connection with petroleum operations through a permanent establishment as a Contractor or Subcontractor m Timor-Leste shall be determined by reference to the income attributable to:

(a) the permanent establishment;
(b) any sales in Timor-Leste of goods or merchandise or the performance of services in Timor-Leste of the same or similar kind as those effected through the permanent establishment.

The taxable income of a non-resident person carrying on business activities in connection with petroleum operations through a permanent establishment as a Contractor or Subcontractor as the case may be in Timor-Leste shall include the income attributable to:

(a) capital gains arising in connection with the alienation of any property within the JPDA and or Timor-Leste exclusive area, including asset, shares or comparable interest, held directly or indirectly in the permanent establishment that is a Contractor or Subcontractor;

(b) the following principles apply in the determination of the taxable income of a Timor- Leste permanent establishment:

i. the profit of the permanent establishment shall be calculated on the basis that the permanent establishment is separate and distinct legal entity engaged in the same or similar services under the same or similar conditions and dealt with wholly independently from the non-resident person of which it is a permanent establishment;

ii. subject to the present Regulations and Section 75 of the Taxes and Duties Act 2008, deductions may be claimed for necessary and ordinary expenses incurred for the purposes of the business activities of the permanent establishment including allowable head office expenditures so incurred, whether in Timor-Leste or elsewhere;

iii. no deduction is allowable to the permanent establishment except where the deductions claimed by the permanent establishment as payment to the head office or another permanent establishment of the non-resident person, other than for the reimbursement of actual expenses incurred by the non-resident person to third parties (not including related party), by way of:

1. royalties, fees, or similar payments for the use of intangible or tangible asset by the permanent establishment;
2. compensation for any services, including management services performed for the permanent establishment;
3. interest on moneys lent to the permanent establishment, except in connection with a transaction involving a bank or banks;

(c) no account is taken in the determination of the gross income of a permanent establishment of amounts charged by the permanent establishment to the head office or to another permanent establishment of the non-resident person, other than towards reimbursement of actual expenses incurred by the permanent establishment to third parties (not including related parties), by way of:

1. royalties, fees, or similar payments for the use of intangible or tangible asset by the permanent establishment;

2. compensation for any services, including management services performed for the permanent establishment;

3. interest on moneys lent to the permanent establishment, except in connection with a transaction involving a bank or banks.

The assessable income of the non-resident person under Section 6 of this Regulation shall be subject to 30% tax in Timor-Leste."

The objective of the TDA Regulations mandate in Section 6.2(b)(i) that the permanent establishment's profit "shall be calculated on the basis that the permanent establishment is separate and distinct legal entity engaged in the same or similar services under the same or similar conditions and dealt with wholly independently from the non-resident person of which it is a permanent establishment" is that transfer pricing principles should be used, to treat the Timor-Leste PE as if it is a separate and distinct legal entity, and therefore requires that transactions between the PE and the other parts of the enterprise (i.e. the head office which maintains the PE in Timor-Leste, and also the affiliated companies of the enterprise which may be outside of Timor-Leste), be computed as if these transactions are done on an arms' length basis.

Section 6.2(a) of the TDA Regulations must be read in conjunction with Article 11 of Annex G to the Timor Sea Treaty[6]. The intent is to make it explicit that capital gains may arise in connection with the alienation of property in the circumstances described both in Article 11 of Annex G to the Timor Sea Treaty and Section 6.2(a) of the TDA Regulations.

Example 3 to Illustrate Section 6.2(a)

Global Energy Corporation (GEC) is a Contractor and a holder of a 60% participating interest in a Production Sharing Contract within the area subject to the TDA Regulations and the Timor Sea Treaty. GEC is organized as a special purpose entity by Pissaro Energy Corporation (PEG), a non-resident company. The principal asset of PEG is the 60% participating interest in GEC PEG sold 50% of the common shares or similar interest in GEC to Santana Oil Company (SANTANA) for US$70 million. The tax basis of PEG in the shares of GEC (is US$25 million. GEC is a Timor-Leste resident permanent establishment (PE).

The excess of the proceed received by PEG in the sum $67.5 million ($12.5m -$70m) will be subject to capital gains tax in Timor-Leste.

[6] Public Ruling 2011/11

While conceptually it may seem simple on the surface, attributing profits to a PE using transfer pricing principles is hardly a simple matter. This area of international tax law is the source of long standing controversy. One issue that proved controversial was whether the reference in to a "separate and distinct" enterprise required the PE to be analyzed as a (hypothetically) distinct entity. In this regard, some jurisdictions applied a "functionally separate entity" approach and treated the PE as equivalent to a stand-alone entity in the jurisdiction, which was engaged in business with third parties and with the rest of the enterprise. Others evaluated the PE as engaged in a "relevant business activity," and viewed the profits attributable to the PE as limited to the profits from that activity. In practice, these approaches could lead to dramatically different attributions of profits to the PE. For example, there exists what is known as the "force of attraction" approach of attributing profits to a PE. Another issue is how to view the capital structure of a PE (that is, how to account for the capital and liabilities of a PE, in relation to the rest of the enterprise) to account for its profits.

Section 7
Tax Subjects

The purpose of Section 7 of the TDA Regulations is to describe the possible types of person or entity who can be "tax subjects", or person(s) who be subject to tax (i.e. taxpayer(s)), for Timor-Leste taxation purposes.

The following types of person(s) are listed as "tax subjects":

(a) a natural person;

(b) an undivided estate as a unit in lieu of the beneficiaries;

(c) a body in the form of a limited company, formed in Timor-Leste;

(d) a partnership, limited or unlimited, formed in Timor-Leste;

(e) any other forms of business, whether private or public, incorporated or formed under Timor-Leste laws;

(f) any legal person established under foreign laws and organized in a manner comparable to entities referred to in paragraphs (c)-(d) above, including trust; or

(g) any other body of persons formed under foreign law.

Under Section 7 of the TDA Regulations, all possible forms of legal person(s) are includible as potential "tax subjects" of Timor-Leste, assuming that the other criteria, such as tax residency in Timor-Leste, existence of a permanent establishment in Timor-Leste, etc., are met with a basis for the imposition of Timor-Leste taxation. However, just because the scope of the term "tax subjects" includes a particular type of person, natural or legal, is itself and without more, not sufficient to subject the "tax subjects" to Timor-Leste taxation. The other legal variables, such as tax residency, income sourced in Timor-Leste, permanent establishment through which business activities are conducted must be present before the "tax subjects" will be subject to Timor-Leste taxation.

TDA Regulations Section 7 also expressly excludes from the scope of "tax subjects" certain governmental and international entities, by listing the following as being exclusions from the definition of "tax subjects":

(a) a representative of a foreign government;
(b) diplomatic and consular representatives or other foreign officials;
(c) international bodies as determined by the Minister of Finance provided they do not conduct business or engage in other for-profit activities in Timor-Leste.

It should be noted however that the exclusion granted under Section 7 of the TDA regulation will not avail any of the persons listed therein if they entered into the zone of commercial activities.

The exclusion of foreign government representatives, diplomatic / consular representatives from "tax subjects" is certainly in line with the practice of many other countries, where provisions exist in the national tax laws to exempt such foreign government related individuals from domestic income taxation. Similarly, certain international bodies (examples include organizations such as the United Nations and its various agencies) are exempt from taxation under domestic tax laws.

Section 8
Taxable Income- What is included?
The first step in computing a taxpayer's income tax for a tax year is to determine what the taxpayer's gross income was for that particular year. Virtually all imaginable types of income are included under Section 8 of the TDA Regulations. However this definition is not an all-encompassing as it appears as result of the fact that the TDA and the TDA Regulations contain numerous provisions that exclude specific types of income from a taxpayer's gross income.

Among the types of income that are specifically includible in a taxpayer's gross income are items like gross profit from business, gains from dealings in property, interest, dividends etc.

The "Return of Capital" Doctrine
Amounts received or accrued are not income if they are return of the capital invested in the business. Thus amounts received as repayment of a debt (loan) are a return of capital, i.e. the money loaned. Only the interest earned from the loan is ordinarily includible as part of the gross income of the recipient. The doctrine also applies when a business asset is used in the production of assets for sale or in the performance of services. In this case, the doctrine allows a portion of the cost or other basis of the asset to be treated as a return of capital each year. The portion characterized as recovered is deducted against the proceed from the sale of the assets produced or sold or from the services performed. This annual subtraction is referred to as "depreciation" (in case of tangible property) or "amortization" (in case of intangible assets).

Conceptual Tax Formula for Corporate Taxpayers

Income (from whatever source)	**$X,XXX,XXX**
Less (Exclusions from gross income)	($xx)
Gross Income	**$xxx,xxx**
Less: Deductions	($xx)
Taxable Income	**xx,xxx**
Applicable Tax Rate	xx%
Gross Tax	**$xx,xxx**
Less-Tax credits & prepayments	($xxx)
Tax Due (or refund)	**$xx,xxx**

Section 8 of the TDA Regulations provides the definition of what is taxable income, in the context of Timor-Leste taxation in the area where the TDA is applicable.

Essentially, the concept of taxable income is that a taxpayer's gross income derived from Timor-Leste sources, less allowable deductions, is subject to Timor-Leste income taxation.

The definitional aspects of a taxpayer's gross income have both (a) economic and (b) accounting dimensions. Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.

One of the key criteria, in a taxation regime, such as what we have in Timor-Leste, is to have a clear concept of what is income, and a practical working definition of the determination of when such income is taxable.

To do so, there are several key concepts:

(a) measurable economic gain

(b) realization event

(c) time period

The above three concepts are essential for a workable definition of what is income which becomes taxable for taxation purposes.

First, for there to be income, there must be a gain from an economic perspective. A person (whether it is a natural person or a legal person), must derive a degree of economic gain or enhancement which can be measured precisely. An example is selling a property at a price higher than what was originally paid for the property.

Second, there must be a triggering event for the economic gain to be realized. In the previous example, the triggering event would be the sale of the property. Arguably, you can have a taxation regime under which a taxpayer needs to "mark to market" all the assets at the end of a fiscal period, and that any economic increases in value, even though has not been "realized", can be subject to taxation. Examples of "mark to market" systems of taxation can be found in some tax jurisdictions[7]. However, these "mark to market" tax regimes (or sub-regimes) occur only in a small number of cases, with the predominant tax regimes around the world adopting the actual realization of economic gain(s) as the triggering event for taxable income recognition. Even in such "mark to market" systems, certain events are adopted and substituted as the "realization" of the economic gains[8]. The Timor-Leste taxation rules do not use the "mark to market" concept at all in the recognition of economic gain as equivalent to income. Instead, the conventional economic realization principle is used as the defining criteria of whether taxable income is recognized, as the result of the occurrence of an economic event which results in the actual realization of income for the taxpayer(s) subject to Timor-Leste taxation.

Third, the concept of time period is integral to the recognition of taxable income for taxation purposes. The realization of economic gain must be related to a particular accounting (fiscal) period, which for taxation purposes is referred to as a "taxable period" or tax year. Without a time period element, it will not be practical to set up a method to impose taxation on income (i.e. the economic gains). There must be a "closing" of the time period for which a taxpayer's taxable income can be measured, so as to arrive at a taxable income base for purposes of income tax

[7] As an example, in the U.S., if a U.S. citizen or resident "expatriates" (ie. renouncing citizenship or residency status), then under certain circumstances, on the date of expatriation, the individual is deemed to have sold / disposed of all her or his assets, at "mark to market" values, such that the individual will be subject to U.S. income tax on the deemed disposal, at mark to market valuation.

[8] In the U.S. example above, the act of "expatriation" is the triggering event substituted for the realization of economic gains

imposition. As most tax regimes in the world, including the tax regime of Timor-Leste, uses a "taxable year" convention, then the income must be classified into a particular taxable year for purposes of the TDA Regulations, such that the income will be taxed in Timor-Leste for a particular taxable year.

Bearing the above general definition of income in mind, the TDA Regulations Section 8 sets our specific items of what is considered as "taxable income":

(a) gains from alienation of property, including:
   i. gains from the transfer of property to a corporation, partnership and other body in exchange for shares or capital participation;
   ii. gains accrued by a corporation, partnership or other body through the transfer of property to shareholders, partners or members;
   iii. gains from liquidation, merger and or acquisition, consolidation, expansion, separation, transfer or takeover of a business;
   iv. gains from the transfer of property in the form of gift, aid or donation, except when given to a related party (by blood or ownership structure);
(b) refunds of tax payments already deducted as expenses;
(c) interest, including premiums, discounts and compensation from loan repayment guarantees;
(d) dividends, in whatever name or form;
(e) royalties;
(f) rent or other income related to the use of property;
(g) gains from cancellation or forgiveness of debt;
(h) gains from foreign currencies;
(i) reimbursements from insurance in respect of losses already deducted as expenses;
(j) lottery prizes or awards;
(k) profits arising from the conduct of any business activities ;
(l) remuneration, wages or other consideration, whether in cash or a property, received or accrued in connection with work or services including salary, allowance, honorarium, commission, bonus, gratuity, and pension.
(m) income from the business or activities of a permanent establishment and from property it owns or control in Timor-Leste;
(n) income of a head office and or a related party arising from the sale of goods or performance of services in Timor-Leste of the same type as those undertaken by the permanent establishment in Timor-Leste; and
(o) any income received or accrued by the head office and or related party, provided the property or activities which produce the income are effectively connected to the permanent establishment.

Section 8(a) (Gains from alienation of property)

Under TDA Regulations Section 8(a), gains from alienation of property is regarded as an item of taxable income.

For Timor-Leste income taxation purposes, the following general rules should be of relevance. Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

The above concept may be illustrated by the following examples:

Example (Section 8(a) Gains from Alienation of Property)

A, a dealer in real estate, acquires a 10-acre tract for $10,000, which he divides into 20 lots. The $10,000 cost must be equitably apportioned among the lots so that on the sale of each A can determine his taxable gain or deductible loss.

Example (Section 8(a) Gains from Alienation of Property)

B purchases for $25,000 property consisting of a used car lot and adjoining filling station. At the time, the fair market value of the filling station is $15,000 and the fair market value of the used car lot is $10,000. Five years later B sells the filling station for $20,000 at a time when $2,000 has been properly allowed as depreciation thereon. B's gain on this sale is $7,000, since $7,000 is the amount by which the selling price of the filling station exceeds the portion of the cost equitably allocable to the filling station at the time of purchase reduced by the depreciation properly allowed.

Example (Section 8(a)(i) Gains from Alienation of Property – When Property is Transferred to a Corporation in Exchange for shares)

Under TDA Regulation Section 8(a)(i), when property is transferred to a corporation in exchange for shares, there can be a trigger of income subject to taxation. This concept can be illustrated by the example below.

Ms. V is a resident taxpayer of Timor-Leste. She owns a property which was acquired by her a year ago for the sum of $100,000. She has decided to acquire from Mr. X a 5% stake in a corporation (the T Corporation) in Timor-Leste which is a Contractor engaged in the drilling of oil. The 5% stake is valued at $500,000. Since Ms. V's property has a current fair market value of $500,000, Mr. X has agreed to exchange Ms. V's property for the 5% equity interest (shares in T Corporation) that Mr. X now owns. Upon concluding the exchange of property for 5% shares in T Corporation from Mr. X, Ms. V has a $400,000 gain which is considered as taxable income subject to Timor-Leste taxation.

Section 9
Exempt Income

Under Section 8 of the TDA discussed above, almost any item seems to fall within the definition as part of gross income of a taxpayer. The TDA Regulations set out certain classes of "income" excludible from gross income.

Section 9 of the TDA Regulations lists certain types of income which is tax exempt for Timor-Leste income taxation purposes.

The following income is exempt from taxable income under Section 9:

(a) aid or donations, provided the donor are not related parties, whether by blood or ownership structure,;

(b) property (including cash) received by a legal person in exchange for shares or capital contribution, provided the contribution was made as part of the capitalization of the legal person and evidenced as a subscription for shares in the books of the legal person

(c) an amount paid by an insurance company to reimburse the taxpayer for a loss, other than a loss that has been previously deducted.

Example (Section 9 – (Exempt Income - property received by a legal person in exchange for shares or capital contribution)

This is a variation of the example used in Section 8 above.
Ms. V is a resident taxpayer of Timor-Leste. She owns a property which was acquired by her a year ago by paying a price of $100,000. She has decided to acquire from 5% stake in a corporation (the T Corporation) in Timor-Leste which is a Contractor engaged in the drilling of oil. The 5% stake is valued at $500,000. However, under these facts, instead of acquiring it from Mr. X, as in the Example under Section 8 above, Ms. V now acquires the shares directly from T Corporation, which is a legal person, and her acquisition is part of the capitalization of T Corporation, together with other investors who are subscribing to the shares of T Corporation. Since Ms. V's property has a current fair market value of $500,000, the T Corporation has agreed to exchange Ms. V's property for the 5% equity interest (shares in T Corporation) as Ms. V's subscription of shares. Upon concluding the exchange of property for 5% shares in T Corporation as part of T Corporation's shares subscription in T Corporation's capitalization, the $400,000 economic gain which is realized by Ms. V, in the exchange of shares with T Corporation, is exempt from taxation in Timor-Leste under the TDA Regulations.

Example (Section 9 – (Exempt Income – donation of property)

Pegasus Oil Corporation (POC) has a landed property which it acquired for $50,000, and which is now worth $500,000. POC decided to donate the land to a school in Dili for expansion, so that it can accommodate more students. Although the market value is higher than POC's cost basis, POC will not realize any taxable income to the extent possible under the limitations imposed by the TDA Regulations.[9] For the school, since it is a donation, it is also not subject to income taxation in the hands of the school.

[9] Section 10(1)(k) of Regulation TDA-IX/12.

Section 10
Deductions Allowed against Income Tax

Deductibility-Generally- A taxpayer, whether a corporation, an individual, a partnership, a trust, or an estate, generally, may deduct from gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred in the tax year. However, a deduction is generally not permissible for any expenditure that is capital in nature. An expense that adds to the value or useful life of an asset is considered a capital expense.

The origin and character of an expense are usually the controlling factors in the determination of whether an expense is deductible business expense or nondeductible personal expense. Whether an expense is ordinary and necessary is based upon the facts and circumstances surrounding the expense. The bright light or safe harbor adopted by the Timor-Leste tax administration is that an expense is necessary it is appropriate and helpful to the taxpayer's business. An expense is ordinary if it is one that is common and expected in the particular business activity.

The objective of Section 10 of the TDA Regulations is to set out the allowable deductions against gross income which a taxpayer may take, in order to arrive at taxable income, upon which the Timor-Leste income tax as provided for under the TDA may be imposed. The basic concept is that the Timor-Leste income tax is a tax on the "profits" of a business enterprise, and not on the enterprise's gross revenue. As an "income tax", the gross income, less expenses which are incurred for the generation of such income, is to result in "taxable income", upon which the incident of the "income tax" should be based.

Generally speaking, TDA Regulations Section 10 allows for business expenses incurred in the production of income, in connection with Petroleum Operations. The first subsection of Section 10 (Section 10(a)) allows for "necessary and ordinary" expenditures incurred.

Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. Among the items included in business

expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away in the pursuit of a trade or business advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

The TDA Regulations Section sets out the following specific expenses, which are as a matter of statute, allowable as deductions against gross income, to arrive at taxable income:

(a) necessary and ordinary expenditures incurred, and losses connected with the alienation of assets used in Petroleum Operations within the Contract Area;
(b) necessary and ordinary expenditures incurred in deriving an amount that is includible as part of gross income, including costs to purchase materials, costs connected with work or services including salaries, wages, honoraria, bonuses, gratuities directly connected with Petroleum Operations in a Contract Area;
(c) interest payment on loans or obligations from a bank and which loans were obtained directly and specifically in connection with Petroleum Operations in a Contract Area and the borrower bears the economic risk of default;
(d) rent, insurance premiums directly connected with Petroleum Operations within a Contract Area;
(e) administrative cost directly connected with Petroleum Operations in a Contract Area;
(f) royalties paid or accrued directly in connection with Petroleum Operations in a Contract Area;
(g) depreciation of tangible assets and amortization of intangible assets and other costs with a useful life of more than one (1) year as provided in Sections 77 and 78 of the Taxes and Duties Act, over which the Contractor has a claim of title in law and located within the working area of the Contractor in Timor-Leste;
(h) loss arising from the sale or transfer of property owned and used in business or owned for the purpose of earning, recovering and securing income in connection with Petroleum Operations in Timor-Leste,; and provided the sale is conducted in open market and not below the fair market value of the property;
(i) loss arising from fluctuations in foreign currencies directly connected with the Petroleum Operations of the Contractor in Timor-Leste;

(j) costs of training, apprenticeship and scholarship awards to citizens of Timor-Leste not exceeding US$50,000 per tax year and subject to the prior approval of the Minister of Finance and such approval must be obtained during the tax year in which the expense was incurred;
(k) charitable contributions to public institutions in Timor-Leste not exceeding US$200,000 per tax year and subject to the prior approval of the Minister of Finance and such approval must be obtained during the tax year in which the expense was incurred;
(l) an amount approved in writing by the Designated Authority as the decommissioning cost reserve for the current tax year under 76.2 of the Taxes and Duties Act;
(m) an amount of Timor-Leste Supplemental Petroleum Tax of a Contractor for the tax year calculated under Section 83 of the Taxes and Duties Act and or Section 32 of the present Regulations.

Net Operating Loss (NOL) Treatment

To the extent that a Contractor may incur expenses exceeding its taxable income, TDA Regulations Section 10.2 allows such net operating loss (NOL) to be carried forward to the following tax year, but restricts the utilization of the NOL in the future year(s) to offset only income arising from Petroleum Operations in the "Contract Area". "Contract Area" is defined under TDA Regulations Section 4 to mean the area which is the subject of a Petroleum Agreement (which is in turn defined under Section 4 as "either (a) a contract, license, permit or other authorization in relation to petroleum operations made or given pursuant to the Timor-Leste Petroleum Act, except Seepage Use Authorization, or (b) an authorization or production sharing contract made under the Code".

Section 11
Non-Deductible Expenses

Under Timor-Leste taxation laws, as in most other tax jurisdictions in the world, expense deductions against gross income is a matter of legislative grace. Therefore, the government has the authority to specifically disallow certain items as deductions against income.

TDA Regulations Section 11 enumerates specific items which are expressly not allowed as deductions against income for purposes of determining taxable income:

(a) distribution of profits such as dividends and by whatever name or form;
(b) penalties of any kind, penal or administrative;
(c) additional taxes imposed under the present Regulations and Sections 72-74 of the UNTAET Regulations 2000/18;
(d) excessive compensation paid by a legal person for work performed and paid to shareholders or related parties as compensation;
(e) incentives, pension fund payments, and insurance premiums for personal interest and/or the families of expatriate employees, management and shareholders;
(f) losses arising from a transaction with a related party where transactions were determined by the Commissioner not to be at arm's-length;
(g) costs incurred for the benefit of a related party or shareholders;
(h) bad debts;
(i) exploration and development costs incurred before the commencement of commercial production and which are required to be capitalized;
(j) reserves, other than approved decommissioning cost reserve under Section 76 of the Taxes and Duties Act;
(k) gifts, scholarship, apprenticeship, aids or donations other than those in accordance with Section 10 of this Regulation;
(l) salaries paid to members of an association, limited or unlimited partnerships without share capital;
(m) costs incurred by a Contractor and not in connection with a Contract Area as defined under the relevant Production Sharing Contract;
(n) if an income taxpayer is required to withhold tax from a payment that is deductible as necessary and ordinary business expense of the taxpayer, including payment of wages, the deduction is not allowed until the taxpayer pays the withheld tax to the Tax Administration;
(o) a fine or other monetary penalty imposed for violation of any law, rule or regulations;
(p) a bribe or any similar amount;
(q) an expenditure or loss incurred to the extent recoverable under a policy of insurance or contract of indemnity;
(r) the acquisition costs of an asset having a useful life of more than one (1) year;
(s) payments made by a permanent establishment to a head office or related party as royalties or other similar compensation in connection with property, patents or other similar rights;

(t) compensation in connection with management services between related parties;
(u) interest payments made by a permanent establishment to a head office or related party except when connected with a debt or loan from a bank and directly connected with Petroleum Operations in Timor-Leste;
(v) the following payments made by permanent establishment to a head office or related party:

1) long-term corporate planning;
2) policy;
3) public and government relations
4) finance\treasury;
5) advertising, donations, sponsorship;
6) entertaining;
7) legal; and
8) intra-group relations.

As can be seen, some of the items which are "disallowed" under TDA Regulations Section 10 are simply provided for so as to be consistent with other sections in the Regulations. For example, under item (r), acquisition costs of an asset having a useful life of more than one (1) year is not really disallowed, but is an acknowledgement that such costs should be "capitalized" so that the costs are to be depreciated over the use life of the asset (i.e. the incurred costs of acquisition), under TDA Regulations Section 16. Similarly, exploration and development costs under (i) are to be capitalized and then the costs are to be amortized under Section 17 of the TDA Regulations.

Deduction for Head Office Expenses

Under TDA Regulations Section 6.2(b)(ii), it is provided that:

> " subject to the present Regulations and Section 75 of the Taxes and Duties Act 2008, deductions may be claimed for necessary and ordinary expenses incurred for the purposes of the business activities of the permanent establishment including allowable head office expenditures so incurred, whether in Timor-Leste or elsewhere"

However, the above provision must be considered in conjunction with the following provisions in these TDA Regulations , which limit the deduction of "head office" expenses:

- TDA Regulations Section 11(s):
    - payments made by a permanent establishment to a head office or related party as royal ties or other similar compensation in connection with property, patents or other similar rights

- TDA Regulations Section 11(t)
    - compensation in connection with management services between related parties

- TDA Regulations Section 11(u)
    - interest payments made by a permanent establishment to a head office or related party except when connected with a debt or Joan from a bank and directly connected with Petroleum Operations in Timor-Leste

- TDA Regulations Section 11(v)
    - the following payments made by permanent establishment to a head office or related party:
        1) long-term corporate planning;
        2) policy;
        3) public and government relations
        4) finance\treasury;
        5) advertising, donations, sponsorship;
        6) entertaining;
        7) legal; and
        8) intra-group relations.

- TDA Regulations Section 11A:
    - the amount of Head Office Expenditures deductible under Section 6.2(b)(ii) of the present Regulation and Section 75 of the Taxes and Duties Act, for a tax year shall be limited to a maximum of **two-percent (2%) of the total deductible expenditures**, excluding any depreciation and amortization deductions under this present Regulations and or the Taxes and Duties Act, 2008.

Therefore, while TDA Reg. Sec. 6(b)(ii) seemingly allows for "head office" expenditures incurred by a permanent establishment ("PE") as deductions against gross income, in determining taxable income, there are significant limitations imposed by other provisions of the TDA Regulations, as explained above.

Section 12
Limitation on Interest Deductions for Contractors

TDA Regulations Section 12 provides for a modification in terms of certain restricting factors of the Section 10.1(c) rules for interest expense deduction of a Contractor,

Section 12 states as follows:

- a Contractor is allowed a deduction for interest expense incurred in relation to petroleum operations where:
  (a) the cost of money to the Contractor is substantially the same as charged in the open market by banks for similarly situated persons;
  (b) the deductible amount is limited to twenty-five percent (25%) of the Contractor's non-interest income for the tax year.

Therefore, while TDA Reg. Sec. 10.1(c) allows for interest expenses incurred by a Contractor on loan(s) (borrowed from a bank or otherwise), in connection with Petroleum Operations in a Contract Area, with the borrower bearing the economic risk of default, TDA Reg. Sec. 12 places two additional requirements:

- the interest cost has to be same as what banks charges others (who are similar to the Contractor)
- the deductible amount is limited to twenty five percent (25%) of the Contractor's income (excluding any interest income the Contractor may have).

Example (Section 12 – Limitation on Interest Deduction for Contractors)

Company TL is a Contractor engaged in petroleum operations in a Contract Area. In 2013, on January 1, Company TL borrowed $20 million from a bank in Singapore, to finance its oil operations in Timor-Leste, in the Contract Area. The interest rate charged by the Singapore bank to Company TL on the loan is 5% per annum, which is the same that the bank charges to other similar enterprises, like Company TL. During 2013, Company TL had a total profit of $3,000,000 (before the deduction of any interest expense).
Company TL had $25,000 of interest income, which is included in the $3,000,000 profit.
Company TL's interest expense payment for 2013 year was $1,000,000.

Therefore, for year 2013, Company TL's allowable interest deduction is computed as follows:
(Total profit – Interest income) x 25%
($3,000,000 - $25,000) x 25% = $743,750 = allowable interest expense deduction for 2013

What if Company TL had borrowed the same amount from a related party called TL Global Energy Finance at 7.5% interest rate? If the tax administration is able to demonstrate that Company TL could have obtained the same loan at 5% from an unrelated party like the Singapore Bank, the additional cost of money in the sum of $500,000 may be disallowed by the Timor-Leste tax administration under Section 12 (1)(a)of the TDA Regulations.

Section 13
Loss and Interest Expense Carry Forward

Net Operating Loss (NOL) Excluding Interest Expense

TDA Regulations Section 13 provides the statutory right of a taxpayer (Contractor) who has incurred a net loss (that is a net operating loss or "NOL"), to carry forward such NOL to future tax years, to offset against future taxable income. However, it should be noted that the interest expense portion of the NOL is given different and separate treatment. The Contractor may carry forward such NOL to future tax years, indefinitely, until the NOL is utilized in full, or until the Petroleum Operations in the Contract Area ceases.

Net Operating Loss (NOL) Attributable to Interest Expense

If a Contractor has incurred interest expenses but which was unable to deduct such interest expense fully, due to the limitation of TDA Section 74.2 (i.e. TDA Regulations Section 12), then such excess interest disallowed may be carried forward for five (5) years. Also, the excess disallowed interest incurred in successive years are to be used in the order in which they were incurred.

Example (Section 13 - Loss and Interest Expense Carry Forward)

The Zonic Company is a Contractor in petroleum operations in a Contract Area. For year 2013, Zonic incurred a $600,000 net operating loss, without having interest expense deductions taken on its tax return. Zonic may carry forward the $600,000 loss to its 2014 tax year to offset any positive income Zonic may realize in that year. If 2014's taxable income was less than $600,000, Zonic can carry forward any unused NOL from the 2013 year to future years, indefinitely, until it is completely used up.

Example (Section 13 - Loss and Interest Expense Carry Forward)

TL Company's 2013 year interest payment on a bank loan is $1,000,000. However, due to the limitation imposed by TDA Section 74.2 (TDA Regulations Section 12), its 2013 year interest expense deduction was limited to $743,750, with $256,250 of interest expense payment disallowed as a deduction.

TL Company may carry forward the $256,250 of disallowed interest expense to its future tax years, beginning with 2014, through 2018 (5 years from the 2013 year), to offset future year taxable income.

Section 14
Basis and Method of Accounting

TDA Regulations Section 14 sets forth the basic accounting standards to be used by a taxpayer, in the determination of taxable income reportable on the tax return of a taxpayer engaged in petroleum operations.

TDA Reg. Sec. 14 provides that:

> "The determination of the gross income and deductions of a taxpayer from the conduct of business activities connected directly or indirectly with petroleum operations shall be based on the taxpayer's net profit for financial accounting purposes for the year. The profit and loss and the balance sheet must be prepared in accordance with the most updated version of the International Accounting Standards or the Generally Accepted Accounting Practices applicable to the taxpayer, and subject to the modifications contained in the present Regulation and the Taxes and Duties Act, 2008."

Note that TDA Reg. Sec. 14 allows a taxpayer the choice of (a) International Accounting Standards ("IAS") or Generally Accepted Accounting Practices ("GAAP") applicable to the taxpayer, in the determination of its taxable income.

"GAAP" can be interpreted that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes income in keeping the taxpayer's books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item and with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and

water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

It is also generally recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in the taxpayer's judgment, best suited to the taxpayer's needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner of Taxation, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in accordance with accepted conditions or will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

The profit and loss statement and balance sheet must be exhibited with the annual income tax return of the taxpayer.

Accrual Basis Method of Accounting Mandated for Timor-Leste Taxation Purposes

The TDA Regulations makes it mandatory for taxpayers to adopt the "accrual basis" to determine taxable income in the Timor-Leste tax regime.

TDA Reg. Sec. provides that:

> " Every taxpayer shall account for income tax on accrual basis. A taxpayer using the accrual method of accounting recognizes income when it is earned or receivable and incurs an expense when its payable. Except for deviations permitted or required by such special accounting treatment under the applicable tax laws and regulations, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books."

Accrual Basis Method – General Overview

The underlying concept of the "accrual basis" method is that economically, income and expenses should be matched and recorded within the same accounting / tax period.

Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

TDA Reg. Sec. 14.3 provides that:

> "Subject to this Regulation, an amount is receivable by a taxpayer when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy, but not before economic performance. Economic performance occurs when:
>
> (a) in the case of acquisition of services or assets, at the time the services or assets are provided;
>
> (b) in case of use of assets, at the time the assets arc used; and
>
> (c) in any other case, at the time the taxpayer makes payment m full satisfaction of the liability.

The term "liability" includes any item allowable as a deduction, cost, or expense for income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term "liability" is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

Example (Section 14 – Economic Performance – Accrual of Liability)

X corporation, an oil and gas company, is an accrual method taxpayer. During March 2013 X enters into an oil and gas lease with Y. In November 2013, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 2016, X removes the platform and well fixtures at a cost of $200,000.

Economic performance with respect to X's liability to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 2016 as, for example, X's employees provide X with removal services. Consequently, X incurs $200,000 for the 2016 taxable year. Alternatively, assume that during 2013 X pays Z $130,000 to remove the platform and fixtures, and that Z performs these removal services in 2016. X does not incur this cost until Z performs the services. Thus, economic performance with respect to the $130,000 X pays Z occurs in 2016.

Please note that Contractor taxpayers are allowed to take ratable decommissioning/deactivation[10] tax deductions before the liability arises. This arrangement is simply an aberration from the normal rules governing deductibility of expenses and it is limited to Contractor taxpayers only.

Example (Section 14 – Accrual Basis - Services or property provided by the taxpayer)

W corporation, a calendar year, accrual method taxpayer, sells oil well drilling equipment under a three-year warranty that obligates W to make any reasonable repairs to each equipment it sells. During 2013, W sells ten tractors. In 2015 W repairs, at a cost of $20,000, two equipment sold during 2013 tax year.

Economic performance with respect to W's liability to perform services under the warranty occurs as W incurs costs in connection with that liability. W incurs these costs in 2015 as, for example, replacement parts are provided to W. Consequently, $20,000 is incurred by W for the 2013 taxable year.

[10] See-Sections 76 of TDA and 4 of TBUCA

Section 15

Inventory

Introduction

The use of inventories at the start and close of each year is required in most every case where production, purchase or sale of merchandise is an income-producing event or factor. Inventories are required to be used where necessary to clearly reflect income and must conform to the best practices in the industry or trade of the affected taxpayers[11].

The term inventory is used to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Depending on the nature of the company's operations, inventories can include raw production materials, work in process, finished goods, and/or merchandise inventory.

In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. Gross profit from business operation is calculated by subtracting from receipts the cost of goods sold. The cost of goods sold is determined by adding the inventory at the beginning of the year to the cost of goods purchased or produced during the year and subtracting from this total the inventory at the end of the year.

[11] Section 15.1(a) and (b) of Regulation TDA-IX/12

The use of accrual basis and inventories more clearly reflects the income of a single accounting period through recognition of unsold goods on hand at the beginning and end of each tax year.

An inventory is an itemized list, with valuations of good held for sale or consumption during manufacturing or merchandising business. Taxpayers are required to clearly verify the amount of items in the inventory by physical count of the items as of the last day of the year. Taxpayers may also use estimates of inventory shrinkage that are confirmed by physical count after year-end if the taxpayer normally does a physical inventory count at each location on a regular and consistent basis and the taxpayer makes proper adjustments to such inventories and to its estimating methods to the extent such estimates are greater than or less than the actual shrinkage.

The balance in this account is also affected by accounting methods. In order to correctly match revenue to expenses, it is necessary to have an accounting methodology which can track the costs of inventory, as costs of the company are incurred to procure or produce the merchandise, which is then eventually sold to the customer at a profit. However, in recognition of the fact that a company may not sell all of its merchandise produced within a single accounting period, and that some of the finished products can still remain on hand at the end of the accounting period (for example, oil or gas which have been extracted from wells, but which are not yet sold within the same year in which the products have been extracted)

Accounting standards permit various acceptable inventory measurement methods, including last-in-first-out (LIFO), first-in-first-out (FIFO), weighted average, and specific identification. An inventory must conform to the best accounting practice in the particular trade or business and it must clearly reflect income. As a rule of thumb, an inventory method selected under the best accounting practice, that can be used in a balance sheet showing the financial position of the taxpayer will generally be regarded as clearly reflecting income by the Timor-Leste tax administration.

Specific identification has been used most frequently for inventories in which the separate items are distinct and have a high cost, because the benefit to be gained from tracking these individual items is high. For lower-cost items in inventory, the value of such specific tracking is low

unless a company is using sufficiently sophisticated databases that allow detailed inventory tracking to be readily accomplished.

Even if a company uses sophisticated technology to control inventory, the accounting measures do not have to reflect precise physical flows, as would occur using specific identification. Rather, the LIFO, FIFO, and weighted average methods refer to assumptions that are made about the flow of inventory through the company. Using LIFO, the costs of the oldest inventory are maintained on the balance sheet under the assumption that the most recently acquired inventory is sold first. Using FIFO, the company assumes that the first goods sold are the oldest and the most recently acquired items remain in inventory on the balance sheet. The weighted average method uses average costs over the reporting period to calculate the inventory balance. The effect of accounting choices on the income statement and balance sheet is presented below. The LIFO method has been excluded as a method which should be used under the IFRS (International Financial Reporting Standards), and the TDA Regulations has also accordingly excluded the use of the LIFO method for taxation purposes.

Method	Assumption	Income Statement Effect	Balance Sheet Effect
FIFO	When a company sells an item from inventory, the oldest one is sold	The older inventory was cheaper, so cost of sales is less and income is higher	The remaining inventory carried on the balance sheet is the newest, and most valuable
LIFO	When an item is sold from inventory, the newest one is sold	The newer (more expensive) inventory is sold, so the cost of sales is higher and income is lower	Remaining inventory is shown as an older and less valuable asset
Average cost	The average cost of all inventory is used for both cost of sales and inventory	Both cost of sales and income will be between the levels recorded under LIFO or FIFO	Inventory asset will be between the levels recorded under LIFO or FIFO

10.2
Under the TDA Regulations, inventories are to be valued at cost or market, whichever is lower. Where inventories are valued at cost by the taxpayer, then the cost shall be determined using the absorption-cost method. See 10.3 below for explanation of the absorption-cost method.

The designation under the TDA Regulations of the principle as the accounting valuation method for inventory of "lower of cost or market" ("LCM") is a recognition of the conservatism principle widely followed by principle economies of the world. In this method the term "market" includes both the market in which the company purchases its merchandise as well as the market in which it sells its merchandise. The lower of cost or market rule as the lower of cost or replacement cost–with certain limitations placed on the replacement cost amount.

As used in the phrase lower of cost or market, the term market means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

10.2.2
Inventory Costing Methods

Under the TDA Regulations, the taxpayer has a choice of the following inventory accounting methods:

a. Specific identification
b. First in First Out (FIFO)
c. Weighted average

If a taxpayer (Contractor) is able to specifically identify particular items of inventory, it may do so and use the first method: specific identification. However, if the taxpayer is unable to specifically identify the inventory units then either the FIFO (first-in-first-out) method or the

weighted average cost method may be used to compute the cost of inventory at the end of a tax period.

The Specific Identification Method

Overview

The specific identification method is the tracking and costing of inventory based on the movement of specific, identifiable inventory items in and out of stock. This method is applicable when individual items can be clearly identified, such as with a serial number, stamped receipt date, or RFID tag.

Specific Identification Method Requirements

The principle requirements of a specific identification tracking system are:

Be able to track each inventory item individually. The easiest method is a durable metal or paper label that contains a serial number. Alternatively, a radio frequency identification tag can contain a unique number that identifies the product.

Be able to track the cost of each item individually. The accounting system should clearly identify the cost of each purchased item, and associate it with a unique identification number.

Be able to relieve inventory for the specific cost associated with an inventory item when it is sold.

These requirements can be achieved with a simple accounting system, possibly just an electronic spreadsheet, which makes it applicable to smaller businesses.

The specific identification method introduces a high degree of accuracy to the cost of inventory, since the exact cost at which something was purchased can be recorded in the inventory records, and charged to the cost of goods sold when the related item is sold.

However, this method is not widely used, because there are few purchased products that are clearly identified in a company's accounting records with a unique identification code. Thus, it is typically restricted to unique, high-value items for which such differentiation is needed. Most

organizations instead sell products that are essentially interchangeable, and so are more likely to use a FIFO, LIFO, weighted average, or similar system.

It is also very time-consuming to track inventory on an individual unit basis, which restricts its use to smaller inventory quantities.

FIFO (first-in-first-out) Inventory method

Overview of the First-in, First-out Method

The first in, first out (FIFO) method of inventory valuation operates under the assumption that the first goods purchased are also the first goods sold. In most companies, this accounting assumption closely matches the actual flow of goods, and so is considered the most theoretically correct inventory valuation method.

Under the FIFO method, the earliest goods purchased are the first ones removed from the inventory account. This results in the remaining items in inventory being accounted for at the most recently incurred costs, so that the inventory asset recorded on the balance sheet contains costs quite close to the most recent costs that could be obtained in the marketplace. Conversely, this method also results in older historical costs being matched against current revenues and recorded in the cost of goods sold, so the gross margin does not necessarily reflect a proper matching of revenues and costs.

The FIFO method is allowed under both Generally Accepted Accounting Principles and International Financial Reporting Standards. The FIFO method provides the same results under either the periodic or perpetual inventory system.

Example 1 (First-in, First-out Method)

M Corporation decides to use the FIFO method for the month of January. During that month, it records the following transactions:

	Quantity Change	Actual Unit Cost	Actual Total Cost
	+100	$210	$21,000
Sale	-75		
Purchase (layer 2)	+150	280	42,000
Sale	-100		
Purchase (layer 3)	+50	300	15,000
Ending inventory	= 125		

The cost of goods sold in units is calculated as:

100 Beginning inventory + 200 Purchased – 125 Ending inventory = 175 Units

M's controller uses the information in the preceding table to calculate the cost of goods sold for January, as well as the cost of the inventory balance as of the end of January.

	Units	Unit Cost	Total Cost
Cost of goods sold			
FIFO layer 1	100	$210	$21,000
FIFO layer 2	75	280	21,000

	175		$42,000
Ending inventory			
FIFO layer 2	75	280	$21,000
FIFO layer 3	50	300	15,000
	125		$36,000

Thus, the first FIFO layer, which was the beginning inventory layer, is completely used up during the month, as well as half of Layer 2, leaving half of Layer 2 and all of Layer 3 to be the sole components of the ending inventory.

Note that the $42,000 cost of goods sold and $36,000 ending inventory equals the $78,000 combined total of beginning inventory and purchases during the month

With first-in, first-out, the oldest cost (i.e., the first in) is matched against revenue and assigned to cost of goods sold. Conversely, the most recent purchases are assigned to units in ending inventory.

Example 2 (First-in, First-out Method)

The following information is used to calculate the value of inventory on hand at the end of the tax year on December 31 and cost of goods sold during December in a FIFO inventory system (using a "periodic costing system").

Dec 1	Beginning Inventory	60 units @ $15.00 per unit
5	Production	140 units @ $15.50 per unit

14	Sale	190 units @ $19.00 per unit
27	Production	70 units @ $16.00 per unit
29	Sale	30 units @ $19.50 per unit

Computation of inventory costs

FIFO Periodic

Units Available for Sale	= 60 + 140 + 70	= 270
Units Sold	= 190 + 30	= 220
Units in Ending Inventory	= 270 − 220	= 50

Cost of Goods Sold	**Units**	**Unit Cost**	**Total**
Sales From Dec 1 Inventory	60	$15.00	$900
Sales From Dec 5 production	140	$15.50	$2,170
Sales From Dec 27 production	20	$16.00	$320
	220		**$3390**

Ending Inventory	**Units**	**Unit Cost**	**Total**
Inventory From Dec 27 production	50	$16.00	$800

Weighted Average Inventory method

The weighted-average method relies on average unit cost to calculate cost of units sold and ending inventory. Average cost is determined by dividing total cost of goods available for sale by total units available for sale.

When using the weighted average method, the cost of goods available for sale is divided by the number of units available for sale, which yields the weighted-average cost per unit. In this calculation, the cost of goods available for sale is the sum of beginning inventory and net purchases. You then use this weighted-average figure to assign a cost to both ending inventory and the cost of goods sold.

Weighted average costing is commonly used in situations where:

- Inventory items are so intermingled that it is impossible to assign a specific cost to an individual unit.
- The accounting system is not sufficiently sophisticated to track FIFO inventory layers.
- Inventory items are so commoditized (i.e., identical to each other) that there is no way to assign a cost to an individual unit.

The net result of using weighted average costing is that the recorded amount of inventory on hand represents a value somewhere between the oldest and newest units purchased into stock. Similarly, the cost of goods sold will reflect a cost somewhere between that of the oldest and newest units that were sold during the period.

Example 1 (Weighted Average method)

M Corporation elects to use the weighted-average method for the month of May. During that month, it records the following transactions:

	Quantity Change	Actual Unit Cost	Actual Total Cost
Beginning inventory	+150	$220	$33,000
Sale	-125	--	--
Purchase	+200	270	54,000
Sale	-150	--	--
Purchase	+100	290	29,000
Ending inventory	= 175		

The actual total cost of all purchased or beginning inventory units in the preceding table is $116,000 ($33,000 + $54,000 + $29,000). The total of all purchased or beginning inventory units is 450 (150 beginning inventory + 300 purchased). The weighted average cost per unit is therefore $257.78 ($116,000 ÷ 450 units.)

The ending inventory valuation is $45,112 (175 units × $257.78 weighted average cost), while the cost of goods sold valuation is $70,890 (275 units × $257.78 weighted average cost). The sum of these two amounts (less a rounding error) equals the $116,000 total actual cost of all purchases and beginning inventory.

In the preceding example, if M Corporation used a perpetual inventory system to record its inventory transactions, it would have to recompute the weighted average after every purchase. The following table uses the same information in the preceding example to show the recomputations:

	Units on Hand	Purchases	Cost of Sales	Inventory Total Cost	Inventory Moving-Average Unit Cost
Beginning inventory	150	$ --	$ --	$33,000	$220.00
Sale (125 units @ $220)	25	--	27,500	5,500	220.00
Purchase (200 units @ $270)	225	54,000	--	59,500	264.44
Sale (150 units @ $264.44)	75	--	39,666	19,834	264.44
Purchase (100 units @ $290)	175	29,000	--	48,834	279.05

Note that the cost of goods sold of $67,166 and the ending inventory balance of $48,834 equal $116,000, which matches the total of the costs in the original example. Thus, the totals are the same, but the moving weighted average calculation results in slight differences in the apportionment of costs between the cost of goods sold and ending inventory.

Example 2 (Weighted Average Method)

S Company incurred $306 for 270 units, producing an average cost of $1.13333 per unit ($306/270). The ending inventory consisted of 120 units, or $136 (120 X $1.13333 average price per unit). The cost of goods sold was $170 (150 units X $1.13333 average price per unit).

10.3

The full absorption costing method of inventory valuation costing is required under the regulations, **if inventories are valued at cost by the taxpayer**.

Full absorption costing is a costing system which treats all costs of production as product costs, regardless weather they are variable or fixed.

The theoretical justification for absorption costing is to adopt the matching principle for all production costs. Fixed production overhead costs are only incurred with the expectation that the resources represented by these costs will be used in the production of inventory. Hence, these costs should be matched against the revenue generated from the sale of that inventory.

Absorption costing requires computing an overhead rate for applying all manufacturing overhead to units produced during the period (or else two overhead rates, one for variable manufacturing overhead and one for fixed manufacturing overhead; or else multiple overhead rates if the company uses activity-based costing). There are important issues related to choosing the denominator in the overhead rate for fixed manufacturing overhead.

The cost of a unit of product under full absorption costing method consists of direct materials, direct labor and both variable and fixed overhead. Full absorption costing allocates a portion of fixed manufacturing overhead cost to each unit of product, along with the variable manufacturing cost.

Example (Full Absorption Costing Valuation method)

The M Company produces a product has the following cost structure.

Number of units produced 6,000

Variable costs per unit:

Direct materials $2

Direct labor $4

Variable manufacturing overhead $1

Variable selling and Administrative expenses $3

Fixed costs per year:

Fixed manufacturing overhead $30,000

Fixed selling and administrative expenses $10,000

Computation of the unit product cost under full absorption costing method

Direct materials $2

Direct labor $4

Variable manufacturing overhead $1

Total variable production cost $7

Fixed manufacturing overhead $5

Unit product cost, as computed under the full absorption cost method = $12

Section 16

Depreciation

Depreciation in general.
Generally, when a taxpayer buys a business asset that has a useful life of more than one year, the cost is usually required to be capitalized and recovered through depreciation deductions under most tax systems. On the other hand, the cost of assets with a useful life of less than one year is deducted as an expense in the tax year that their cost is incurred.

The cost of an improvement that increases the value of a property or makes it more useful, or lengthens the useful life is generally required to be capitalized and depreciated.
The tax theory or policy behind depreciation is that if a business could reduce one year's gross income by an expense deduction for the total cost of an item that is used by the business for a number of years, the result would be an understatement of net income during the years that the asset is in use. Accordingly, in order to accurately determine the net income of a business on a year-by-year basis, the cost must be allocated (i.e. depreciated) over the number of years that the asset will be considered used in the taxpayer's business. The covered period (i.e. the "tax life" of the asset) is referred to as the "recovery" or "depreciation" period. The length of the "tax life" is usually contained in the tax law or the underlying regulations.

For income tax purposes, a depreciable property, is a property that is:
1. Is used in business or for the production of income;
2. has a useful life that is longer than a year, and
3. is something that wears out, decays, become obsolete, or less value from usage or natural causes.

Examples of depreciable property are automobiles, machines, and building (but not the land upon which the building is erected).

Amortization is similar conceptually to depreciation but applies only to intangible assets, such as software, patent, copyrights and trademarks.

The deduction for **depletion** is comparable to depreciation, except that the concept of depletion applies only to natural resources, such as oil and gas wells, mines, standing timber and geothermal deposits. The underlying theory of the concept of depletion is that the value of the property is declining as the natural resources is extracted or sold.

In consideration of the principle of the proper matching of income and expenses, the concept of depreciation and amortization are adopted within the generally accepted accounting principles (GAAP) in use in most modern economies. Depreciation is used as the basis to allocate the historical cost of an asset over its useful life in order to conform with the idea that the earnings of

an economic entity is matched accordingly with relative expenses including the wear and tear of the assets used in production, operations and other administrative purposes.

Thus, in measuring these fixed expenses, there are certain elements that should be taken into consideration namely historical cost, estimated useful life and residual or salvage value. Historical cost pertains to the purchase price of the asset while residual or salvage value is the expected value of the asset after its estimated usage. Likewise, estimated useful life is the time period wherein the asset is deemed economically beneficial for the economic entity.
Depreciation is the systematic allocation of a tangible's asset historical cost less its expected residual or salvage value over its estimated useful life.
Depreciation can be measured using a variety of methods the most basic of which is the straight line method. The straight line method is the simple equal allocation of the depreciable amount over the useful life.

Straight-line depreciation. If straight-line depreciation is used, an asset's annual depreciation expense is calculated by dividing the asset's depreciable cost by the number of years in the asset's useful life.

Calculating Straight-Line Depreciation

$$\frac{\text{Depreciable Cost}}{\text{Useful Life in Years}} = \text{Annual Depreciation Expense}$$

Another way to describe this calculation is to say that the asset's depreciable cost is multiplied by the **straight-line rate**, which equals one divided by the number of years in the asset's useful life.

Calculating Straight-Line Depreciation

$$\frac{1}{\text{Useful Life in Years}} = \text{Straight-Line Rate}$$

$$\text{Straight-Line Rate} \times \text{Depreciable Cost} = \text{Annual Depreciation Expense}$$

Suppose a company purchases a $90,000 truck and expects the truck to have a salvage value of $10,000 after four years. The depreciable cost of the truck is $80,000 ($90,000 – $10,000), and the asset's annual depreciation expense using straight-line depreciation is $20,000 ($80,000 ÷ 4).

Cost	$90,000
Less: Salvage Value	(10,000)
Depreciable Cost	$80,000

The following table summarizes the application of straight-line depreciation during the truck's five-year useful life.

Straight-Line Depreciation							
		Depreciable Cost					
Cost							$90,000
Year 1	25%	×	$80,000	=	$20,000	$20,000	70,000
Year 2	25%	×	80,000	=	20,000	40,000	50,000
Year 3	25%	×	80,000	=	20,000	60,000	30,000
Year 4	25%	×	80,000	=	20,000	80,000	10,000

At the end of year four, the $80,000 shown as accumulated depreciation equals the asset's depreciable cost, and the $10,000 net book value represents its estimated salvage value.

To record depreciation expense on the truck each year, the company debits depreciation expense–vehicles for $20,000 and credits accumulated depreciation–vehicles for $20,000.

Under the TDA Regulations (Section 16.1) depreciation deductions are permissible only when the Contractor is the legal and titled owner of the asset, and the asset is in furtherance of the business activities of the taxpayer and exclusively in connection with a petroleum project. This means that the tangible asset has to be legally owned by the Contractor.

Generally speaking, incidents of ownership for purposes of the TDA Regulations include the following characteristics:

The Contractor possesses the following:

- Legal title to the property;
- Legal obligation to pay for the property;
- Responsibility to pay maintenance and operating expenses;
- Duty to pay any taxes on the property; and
- Risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

If an asset is used for more than one petroleum project, then the cost basis of the asset cannot be depreciated for just one project, but should be prorated among the various projects.

(a) Reasonable allowance. The Regulations provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) Useful life. For the purpose of the TDA Regulations the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may

reasonably be expected to be useful to the taxpayer in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination

(c) Salvage. (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset.

However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the

amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

TDA Regulations

For purposes of the TDA Regulations, costs which are incurred for acquisition, construction, installations, improvements and repairs which enhance the value of assets with a use life of over one year are to be capitalized and depreciated.

If assets are depreciated on an individual basis, the straight line method must be used. However, if depreciation is done on a "pooling of assets" basis, then the declining balance method may be used. See TDA Regulations Section 16.1(c).

TDA Regulations – Depreciation for Buildings

For acquisition and construction costs, improvements or repairs that enhance the value or convert the asset from one use to the other or prolong the life of a business building are required to be depreciated on a straight line basis, in accordance with the useful lives / rates based under the TDA Regulations (see TDA Regulations Section 16.1(a)). The rates to be used are those in Schedule X, Section A, Business Buildings of the TDA, which is reproduced at the end of this section below.

If the taxpayer elects the classification of business building assets into pools of similar assets, the depreciation deduction for each depreciation pool is computed by applying the rates in TDA Schedule X, Section B, parts 1 and 2, which is reproduced at the end of this section below.

If the taxpayer elects the individual straight line depreciation method for business building assets, then the rate to be used is specified in Schedule X, Section B, Business Buildings of TDA (Taxes and Duties Act), which is reproduced at the end of this section below.

Change of Depreciation Method

If the taxpayer wishes to change a method of depreciation previously elected, then the taxpayer will need to apply in writing to the Timor-Leste Tax Administration to make the change, stating the basis of the application, and then affirm under oath that the change requested will not distort the income and expenses of the taxpayer.

Depreciation and Amortisation for Contractors

SECTION A Business Buildings

1. The rates of depreciation for business buildings are:

Type of Building	**Useful Life**	**Straight-line Depreciation**
Permanent	20 years	5%
Non-permanent	10 years	10%

2. In this Section:

"non-permanent building" means any business building constructed of materials of a temporary nature, or for temporary purposes, including any movable building; and

"permanent building" means any business building other than a non-permanent building.

SECTION B Depreciable Assets

1. If pooling applies, depreciable assets are divided into the following depreciation pools:

Pool 1	Assets with a useful life of 1-4 years
Pool 2	Assets with a useful life of 5-8 years
Pool 3	Assets with a useful life of more than 9 years

2. Depreciation rates for depreciation pools:

Pool	Depreciation rate
1	50%
2	25%
3	12.5%

3. Depreciation rates where assets are depreciated individually on a straight-line basis:

Useful Life	**Depreciation Rate**
Assets with a useful life of 1-4 years	25%
Assets with a useful life of 5-8 years	12.5%
Assets with a useful life of more than 9 years	6.25%

Section 17
Amortization

In the context of the TDA Regulations, for costs incurred in the exploration and or development stages of oil and gas property, and which are not for the acquisition of tangible property, such costs are categorized as the creation of "intangible asset". Then, the "intangible asset" is classified into four possible "use life" classifications, and the cost of the asset will then be amortized on a straight line basis, over the assigned use life scheme under the TDA. In a sense, this is very similar to the treatment of tangible property .

Conceptually then, the rationale for having the amortization for the costs identified as for intangible assets is similar to that of depreciation. Amortisation is necessary in consideration of the principle of the proper matching of income and expenses, the concept of amortization is adopted within the generally accepted accounting principles (GAAP) in use in most parts of the world. Amortisation is used as the basis to allocate the historical cost of an intangible asset over its useful life in order to conform with the idea that the earnings of an economic entity is matched accordingly with relative expenses used in production, operations and other administrative purposes.

Intangible property which is subject to amortization must be property held either for use in a trade, business, or for the production of income. Because intangible assets may not necessarily be subject to "wear and tear", it is therefore purely an accounting concept adopted for the purpose of approximately matching income to the gradual write down of an intangible asset – in this case, the costs incurred for the exploration and development of the oil / gas well(s).

Start-up expenditure

For amortization as it relates to start-up expenses for a new business or activity. Start-up expenditures are defined as investigatory expenses incurred prior to commencing a business (in this case the production of income when an oil / gas well has started successfully to produce the oil / gas output) which would have been deducted had it been paid or incurred when the taxpayer was already engaged in the trade or business activity.

The costs of determining the existence, location, extent, or quality of any mineral deposit are ordinarily capital expenditures. The costs of developing oil, gas, or geothermal wells are capital expenditures. You can usually recover them through amortization.

Examples of exploration costs are:

- costs of topographical, geological, and geophysical studies, and salaries and other expenses of geologists, geophysical crews, and others conducting those studies
- Geological and geophysical costs
- Wages and related payroll costs in exploration activities
- Legal and professional expenses

Examples of development costs are:

- Costs to gain access to and prepare well locations for drilling, including surveying well locations
- Drill and equip development wells, development-type stratigraphic test wells
- Acquire, construct, and install production facilities
- Interest expense incurred on financing of construction
- Wages and related payroll costs in development activities
- Legal and professional expenses

For costs incurred in respect of petroleum activities, other than the acquisition of tangible assets, are considered to be “intangibles”. Intangibles are to be amortized in accordance to the provisions of Section 17 of the TDA Regulation-IX/12

For purposes of Section 17 Development Expenditures incurred under a Petroleum Agreement is classified as intangible expenditure with a useful life equal to the expected life of the Petroleum Operations under the Agreement or ten (10) years, whichever is lesser.

Exploration and Development Expenditures are required to be amortized on a straight-line basis only and the amortization deductions for each tax year is calculated by applying

the rates specified in Schedule X, Section C of the Taxes and Duties Act 2008, which is reproduced at the end of this section below.

Any depreciable or intangible asset acquired, created, constructed or incurred before the commencement of commercial production is required to be capitalized and the depreciation or amortization deductions of such asset commences from the time commercial product commences.

Amortization in the Year that Commercial Production Commences

In the tax year in which commercial production commences, the amount of the depreciation or amortisation deduction in respect of a depreciable asset or intangible acquired, created, constructed, or incurred by a Contractor before commercial production is calculated according to the following formula, in accordance with TDA Section 77.6:

A x B/C

where:

A is the depreciation or amortisation deduction if commercial production commenced on the first day of the tax year;

B is the number of days from the date of commencement of commercial production to the end of the tax year in which commercial production commences; and

C is the number of days in the tax year.

The following example illustrates the application of Section 17

Example

In the course of exploration of an oil well, intangible asset costs which were incurred exclusively for a petroleum project amounted to $ 300,000, and the useful life is estimated to be three (3) years.

Cost of the intangible asset is: $300,000 = A

Applicable amortization rate prescribed in Schedule X, Section C of the TDA is 25% = B

The amortization for a full year of use of the intangible asset is: A x B = $300,000 x 25% = $75,000

Example (Section 17 – Amortization in Year that Commercial Production Commences)

Continuing the same facts as in the Example above, and that in the year 2013, the first production commences on June 1, 2013.

The amortization deduction is then to be computed using the formula in TDA Section 77.6.

Therefore, the number of days from the date of first production until the end of the tax year is 214 days (for the months of June, July, August, September, October, November and December 2013), so that B = 214

The total number of days in the year is 365 = C

Therefore, for the year of first production, the amortization allowable would be:

A x B/C

A is the amount determined for a full year of depreciation, as explained under 8.3 above = $75,000

B = 214

C = 365

Therefore, the depreciation for the 2013 year (when production first commences) is:

$75,000 x 214/365 = $43,973

If the costs incurred for intangible costs had occurred before the first production date, the deduction for the amortization costs for tax purposes cannot begin until after the date of first production. For example, if the costs in the example in 8.4 above were incurred during the year 2012 in the amount of $300,000, but the first production commences on June 1 2013, no

deduction would be allowed for amortization for the 2012 tax year. A deduction of amortization for the intangible costs will only be allowed beginning for the year 2013, and as computed on a pro-rated basis as explained above.

Section 18
Small Field: Depreciation and Amortization

TDA Regulations Section 18 essentially allows the taxpayer to elect the "units of production" method for depreciation and amortization for all depreciable assets, provided that the field is determined by the Designated Authority to be a " *small field.* "

A " *small field* " is defined to be a field which produces eighty percent (80%) or more of the estimated Reserves within five (5) years from the date of the commencement of commercial production (as determined under TDA Section 77.5).

Once elected by the taxpayer, the "unit of production" method of depreciation and amortization is to be adopted for all of the taxpayer's assets used in the Petroleum Operations. However, if a Contractor has more than one Development Plan for a Contract Area, then the section will apply separately to each Development Plan.

Units of Production Depreciation - Overview

Under the units of production method, the amount of depreciation that charged to expense varies in direct proportion to the amount of asset usage. Thus, depreciation is charged more in periods when there is more asset usage, and less depreciation in periods when there is less asset usage. It is the most accurate method for charging depreciation, since it links closely to the wear and tear on assets. However, it also requires that the tracking of asset usage. Also, you need to be able to estimate total usage over the life of the asset.

Generally, the following steps are needed to calculate depreciation under the units of production method:

1. Estimate the total number of hours of usage of the asset, or the total number of units to be produced by it over its useful life.
2. Subtract any estimated salvage value from the capitalized cost of the asset, and divide the

total estimated usage or production from this net depreciable cost. This yields the depreciation cost per hour of usage or unit of production.

3. Multiply the number of units of actual production by the depreciation cost per hour or unit, which results in the total depreciation expense for the accounting period.

If the estimated number of usage or units of production changes over time, then incorporate these changes into the calculation of the depreciation cost per hour or unit of production. This will alter the depreciation expense on a go-forward basis.

Example (Section 18 – Small Field Depreciation / Amortization - Units of Production Method)

Pensive Corporation's gravel pit operation, Pensive Dirt, builds a conveyor system to extract gravel from a gravel pit at a cost of $400,000. Pensive expects to use the conveyor to extract 1,000,000 tons of gravel, which results in a depreciation rate of $0.40 per ton (1,000,000 tons / $400,000 cost). During the first quarter of activity, Pensive Dirt extracts 10,000 tons of gravel, which results in the following depreciation expense:

= $0.40 depreciation cost per ton x 10,000 tons of gravel

= $4,000 depreciation expense

Section 19

Decommissioning Costs Reserve and Decommissioning Expenditure

Under the Regulations, a Contractor may claim a deduction for the annual amount transferred to a reserve meant to decommission a petroleum project. The amount of the deduction is calculated in accordance with a prescribed formula. However, in order for the reserve amount to be legally taken as a deduction on the Contractor's income tax return, there must first be an "authorization" obtained in writing from the Designated Authority.

The decommissioning reserve deduction is a departure from the tax policies discussed previously in respect of deductible expenditures. The decommissioning reserve deduction is the only allowable tax deduction permissible under both the TDA and TBUCA in respect of expenses that are futuristic. The decommissioning is anticipated to occur at some point in the future when the wells are no longer commercially viable for the Contractors. At that point, the Contractors are expected to incur some cost to "plug" the well and decommission their plants. The decommissioning reserve is set up for that purpose but the taxpayers are permitted (if certain conditions discussed below are met) to take current year deduction for the future expenditure connected with decommissioning the plant.

It is emphasized that, as a **condition precedent** to the tax deductibility of Decommissioning Cost, a Contractor is required to exhibit a copy of the approval granted by the Designated Authority to the annual tax return submitted to the Commissioner and in which a claim is made for such deduction against the taxable income. If a taxpayer's deduction amount for the Decommissioning Costs exceeds the amount "**Total Approved Decommissioning Costs**", the amount of the excess shall be includible in the gross income of the Contractor in the tax year in which the excess occurs.

Under the Regulations, it is provided that the amount of Deactivation Cost deductible in a current tax year shall be calculated on the basis of the formula prescribed under TDA Section 76.3.

Pursuant to Section 76.3 of the TDA, the formula for calculating the deductible Decommissioning expenditure for a given tax year is as follows: l

Decommissioning expenditure incurred by a Contractor in a tax year (referred to as

the "current tax year") is not deductible except to the extent that the total amount of decommissioning expenditure incurred by the Contractor in the current tax year and previous tax years exceeds the amount calculated according to the following formula:

(A + B) – C

where:

A is the total amount deductible under Section 76.1 in the current tax year and previous tax years;

B is the total amount deductible under this subsection in previous tax years; and

C is the total amount included in the Contractor's gross income under Section 76.4 in the current tax year and previous tax years.

Example (Reserve for Decommissioning Costs Expenditure)

Company E, a Contractor, relying on a Decommissioning plan approved in writing and in advance of the current tax year by the Designated Authority for the sum of $500 million. The approved Decommissioning plan is for a fixed 10 year period and deductible ratably in the sum of sum of $50 million per year. In preparing its 2012 Timor-Leste income tax return, Company E deducted US$50m and exhibited a copy of the plan Decommissioning Cost Reserve approved by the Designated Authority. The Timor-Leste tax administration will in all likelihood allow the DCR tax deduction in the sum of $50 million as claimed by Company E.

If the other hand Company E merely relies on a proposal submitted to the Designated Authority and without any prior approval in writing by the Designated Authority or the approved DCR was not exhibited to the tax return, the Timor-Leste tax administration will mostly reverse the deduction claimed by Company E for the 2012 tax year.

Example (Reserve for Decommissioning Costs Expenditure)

Company T, a Contractor, relying on a Decommissioning plan approved in writing and in advance of the current tax year by the Designated Authority for the sum of $500 million. The approved Decommissioning plan is for a fixed 10 year period and deductible ratably in the sum of transferred the sum of $50 million per year. Assume further that following the formula

prescribed in Section 76 of the TDA, the taxpayer calculated its allowable DCR deduction to be $55 million for the 2013 tax year. The Timor-Leste tax administration will only allow the sum of $50 million as computed under the approved plan and the excess ($5 million) will be added to the 2013 gross income of Company T.

Section 20
Transfer of a Petroleum Agreement

This section of the TDA Regulations addresses the taxation issues when an interest (right, stake) in a petroleum agreement / project is transferred or disposed of by a Contractor. The purpose of Section 20 of the TDA and Sections 79 and 88 of the TDA and two fold:

1. Discourage "loss trafficking" , and
2. preserve the tax basis of the assets transferred by the transferor to the transferee.

Under the Regulations, a Right or Stakes in a Petroleum Project is deemed to be transferred by a Contractor under one or more of the four (4) factors listed below, namely:

- 50% of the voting rights or value of the Contractor is transferred or sold directly or indirectly, to another person, including an entity controlled by the Contractor or controlling the Contractor
- all or substantially all of the assets of the Contractor is sold or transferred to another person
- where a statutory or de facto merger, acquisition, reorganization, amalgamation, liquidation, change of name followed by or preceded by transfer of more than 50% of the voting shares or value of the Contractor to another person
- a mere change in identity, form or place of organization of one corporation, however effected, if it is accompanied by either the exchange of shares for cash or other value or the transfer of asset connected with Petroleum Operations from one Contractor to the other

Then, the Regulations provide that, where there is "**continuity of business purpose**" of the transferor Contractor, the transferee Contractor shall "succeed to the balance of deferred tax asset of the transferor Contractor and continue to amortise any Exploration or Development Expenditure in the manner and on the same basis as the original transferor Contractor".

For the purposes of these Regulations, "**continuity of business purpose**" is defined as where the transferee Contractor is engaged immediately after the transfer of a Petroleum Agreement in an actively conducted trade or business which has been so conducted under the transferred

Petroleum Agreement throughout the five-year period ending on the date of the transfer by the transferor Contractor in Timor-Leste.

While TDA Regulations Section 20 provides for rules on how a transferee Contractor is to succeed to certain tax characteristics of a transferor Contractor after the transfer of a Petroleum Agreement, it does not directly address the taxability of the "transfer" itself.
The taxability of a transfer of all or part of a Contractor's interest or stakes in a Petroleum Agreement is actually addressed by TDA Regulations Section 5.1(e).

Under TDA Regulations Section 5.1 (e) provides that income from the alienation of:

(i) any property or right referred to in TDA Regulations Section 5.1 (d)
or
(ii) any ownership interest in a legal person the assets of which consist wholly or principally of property or rights referred to in TDA Regulations Section 5.1 (d).

is considered to be Timor-Leste source income.

The property or rights referred to in TDA Regulations Section 5.1 (d) is defined as either:

(a) income from the lease of immovable property in Timor-Leste whether improved or not,
or
(b) from any other interest in or over immovable property, including the right to explore for, or exploit, natural resources, in Timor-Leste;

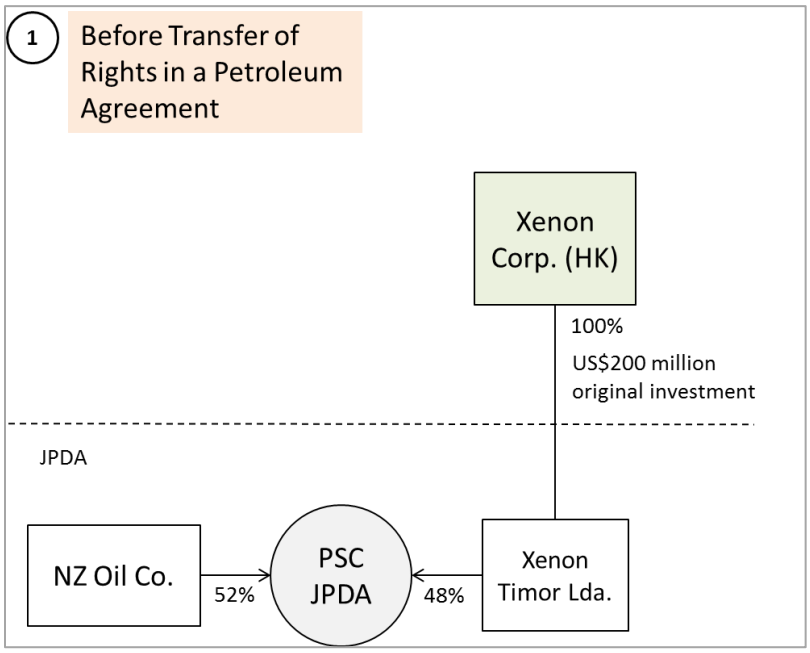
Therefore, if a Contractor sells / transfers in exchange for valuable consideration the right to explore or exploit natural resources (such as a petroleum or gas field), then it is selling / transferring the property or rights as defined in TDA Regulations Section 5.1(d), and is therefore considered to have derived Timor-Leste source income, and which is taxable under Timor-Leste tax laws.
Notice that TDA Regulations Section 5.1(e) refers to the income from the alienation of "any ownership interest "in a Section 5.1(d) right or property, and classifies such income as

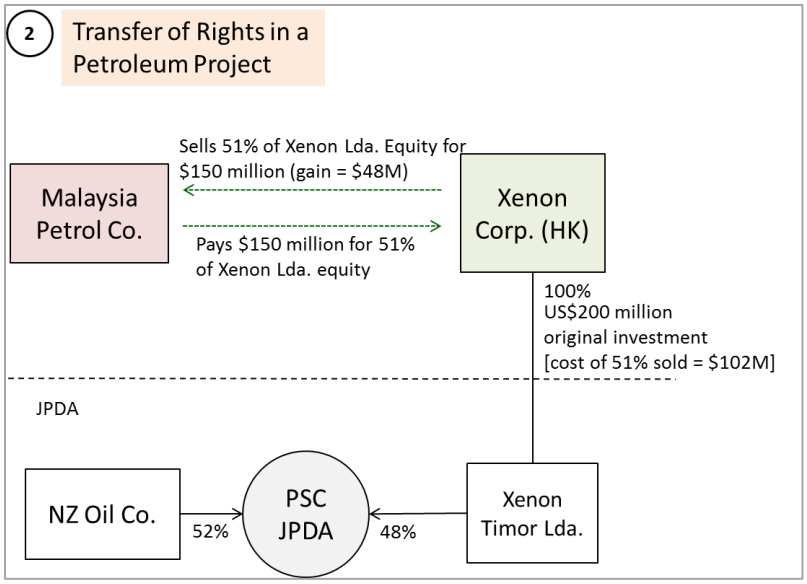
Timor-Leste source income. It does not require a transfer of the entirety (i.e. 100%) of the transferor interest in the rights or property.

If a Contractor, as a legal person, owns a certain percentage of the right or stakes in a petroleum project (which is certainly within the definition of TDA Regulations Section 5.1(d) as a" right to explore for, or exploit, natural resources, in Timor-Leste), and all or a portion of the equity interest of the Contractor (i.e. as a legal person) is being sold or transferred for valuable consideration, then this would be considered as Timor-Leste source income for purposes of TDA Regulations Section 5.1 (e), and therefore would be subject to income tax under Timor-Leste tax law.

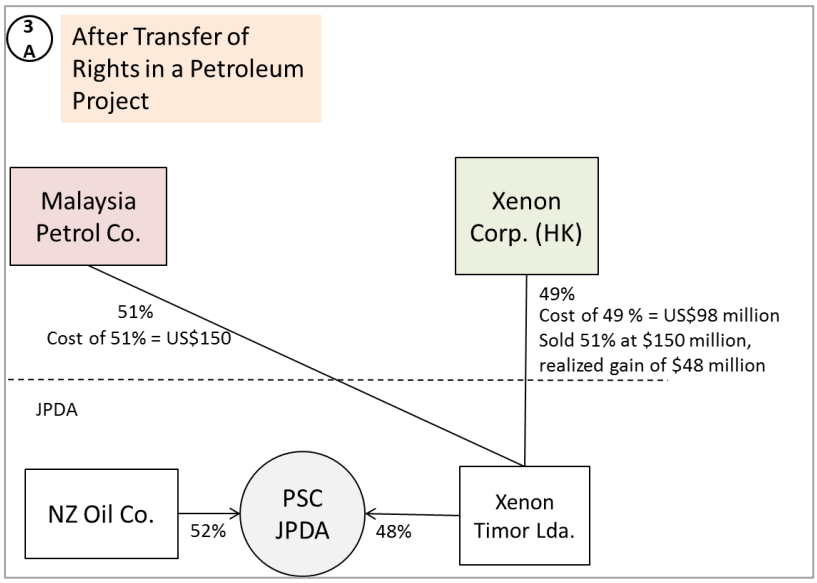
Example (Section 20 - Transfer of Rights in a Petroleum Agreement– Taxability of transfer of equity)

Xenon Corp., a Hong Kong company, owns 100% of Xenon Timor Lda., a Contractor which has a 48% stake under a Petroleum Agreement in Timor Leste. A Production Sharing Contract (PSC) designated as PSC JPDA 9999 was executed between the joint venture partners (including Xenon Timor Lda) and the Designated Authority . The only asset of Xenon Timor Lda is the fractional participating interest in PSC JPDA 9999. Xenon Corp had invested US$200 million to capitalize Xenon Timor Lda., allowing Xenon Timor Lda to acquire its 48% stake. Then, Xenon Corp. agreed to sell 51% of the equity of Xenon Timor Lda to an unrelated company, the Malaysia Petrol Co., for $150 Million





Then, after the sale / transfer, Xenon Corp. will own 49% of Xenon Timor Lda.

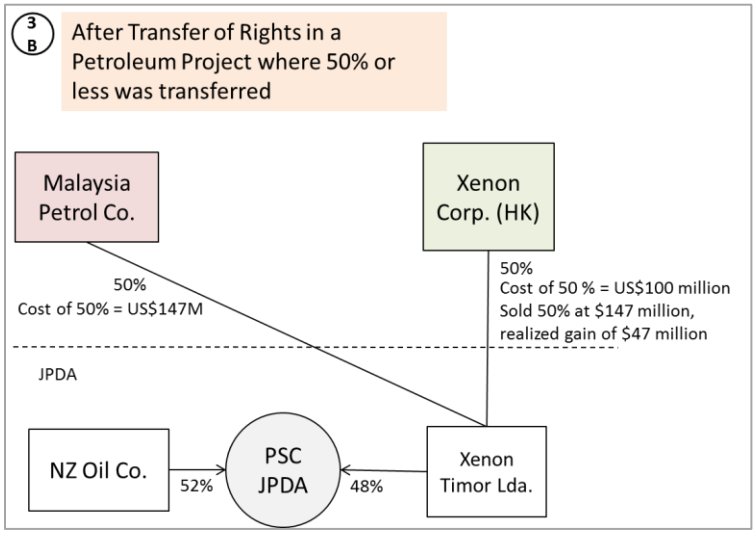


Because Xenon Corp. has realized income (in this case, a gain of $48 million) from the alienation of an ownership interest (i.e. the 51% equity) in a legal person (Xenon Timor Lda.) with assets consisting principally of rights referred to in TDA Regulations Section 5.1 (d) (i.e. the right to exploit oil, a natural resource, in Timor-Leste), then Xenon Corp. has realized Timor-Leste source income in the amount of $48 million, which is subject to income tax under Timor-Leste tax law.

Even if the ownership interest of Xenon Timor Lda. being sold is not the majority interest (i.e. not exceeding 50%), the result should be the same. See diagram below. Under TDA Regulations, the sale of "any ownership interest" will result in the income realized to be classified as Timor-Leste source income, as there is no requirement that the ownership interest being sold to be a controlling or majority interest for the sourcing rule to apply.

It should be noted that the principle expressed above, of taxing the sale of an ownership interest of a legal person, which owns the right to exploit natural resources, is very much consistent with international taxation principles which are widely adopted in the world. When a legal person (such as a corporation, partnership, or other types of legal entities) owns mostly real estate as its assets, a commonly recognized and adopted taxation principle is that the country where the real estate is located should have the legal right to impose income tax on the income / gain realized from the sale of the equity of such a legal entity (legal person). For this purpose, real estate is typically interpreted to include natural resources or the rights to exploit it. This theory is consistent with the interpretation adopted by the Timor-Leste tax administration in respect of Article 11 of Annex G to the Timor Sea Treaty.

Therefore, if the end result is as described in the diagram below, the taxation treatment will not differ from the one above.



Section 21

Allocation and Reallocation of Income and Expenditures among Related Parties and or Associates/Anti-avoidance Rules & Policies

Under the TDA Regulations, Section 21, the Commissioner has authority to reallocate or reapportion income, deductions credits or allowances among related parties and /or associates. These TDA Regulations sections essentially embody the substantive transfer pricing rules under the Timor-Leste tax regime. To understand and effectively apply these TDA Regulations in the reallocation or reapportioning of income, deductions as between related parties, it is necessary to have a basic understanding of the concepts of transfer pricing. To provide the background for the understanding of the Timor-Leste rules on transfer pricing, a synopsis of the basic concepts are stated below

Rationale and Objectives of Transfer Pricing Rules in the TDA Regulations

Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world.

A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called "intra-group" transactions. In addition, transactions involving intangibles and services constitute a rapidly growing proportion of an MNE's commercial transactions and have greatly increased the complexities involved in analyzing and understanding such transactions.

The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the interests of the entities of a group.

In such a situation, it becomes important to establish the appropriate price, called the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services. Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. "Transfer pricing" therefore refers to the setting of prices for transactions between associated enterprises the transfer of property or services. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between companies that are not associated and can be assumed to operate independently ("on an arm's length basis") in reaching terms for such transactions.

"Transfer pricing" thus does not necessarily involve tax avoidance as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration of Timor-Leste, just as the tax administration of other jurisdictions, may consider this to be "mispricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise.

Consider a profitable company group in country A that buys "oil well drilling machinery bits" from its own subsidiary in country B: how much the parent company in country A pays its subsidiary company in country B (the "transfer price") will determine how much profit the country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm's length price, the country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed machinery is sold.

From the perspective of the tax authorities, country A's tax authorities might agree with the profit reported at their end by the machinery group in country A, but their country B counterparts may not agree - they may not have the expected profit to tax on their side of the operation. If the machinery company in country A bought its drilling bits from an independent company in country B under comparable circumstances it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or

subsidiary, whichever is in a low- tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimizing its tax incidence.

When the various parts of the organisation are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct arm's length price, or at least an "arm's length range" of prices needs to be arrived at.

A possible reason for associated entities charging transfer prices for intra-group trade is to measure the performance of the individual entities in a multinational group. The individual entities within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the entities. However not every entity would necessarily make a profit or loss in arm's length conditions. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an associated entity if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. Prices should on this basis gravitate towards the so-called "arm's length price", the transaction price to which two unrelated parties would agree.

While the above explanation of transfer pricing sounds logical , arriving at an appropriate transfer price may be a complex task particularly because of the potential difficulties in identifying and valuing intangibles transferred and / or services provided. For example, intangibles could be of various different types such as: industrial assets like patents, trade types, trade names, designs or models, literary and artistic property rights, know-how or trade secrets. Sometimes such intangibles are reflected in the accounts and sometimes not. Thus, there are many complexities involved which have to be taken into account while dealing with transfer pricing in cross-border transactions between MNE entities.

In business economics a transfer price is considered as the amount that is charged by a part or segment of an organisation for a product, asset or service that it supplies to another part or segment of the same organisation.

It is in recognition of the above reasons that the tax regime of Timor-Leste has adopted the concepts and rules as embodied in the TDA Regulations, so as to be able to determine the fair apportionment of the taxable income and or expenditure of a taxpayer, which is a MNE (multi-national enterprise) which does business in Timor-Leste.

Basic issues underlying Transfer Pricing

Transfer prices serve to determine the income of two or more entities of a MNE (multi-national enterprise) involved in the cross-border transaction. The transfer price therefore tends to shape the tax base of the countries involved in cross-border transactions.

In any cross-border tax scenario, the parties involved are the relevant entities of the MNE group along with the tax authorities of the countries involved in the transaction. When one country's tax authority (such as Timor-Leste) adjusts the profit of a member of the MNE group, this may have an effect on the tax base of another country (for example, if the member whose profit is being adjusted by Timor-Leste has a transaction with a related party, in say, Malaysia, then the profit of such related party in Malaysia can be correspondingly affected). In other words, cross border tax situations involve issues related to jurisdiction, allocation of income and valuation.

The key jurisdiction issues are which government should tax the income of the group entities engaged in the transaction, and what happens if both governments claim the right to the same income. If the tax base arises in more than one country, should one of the governments give tax relief to prevent double taxation of the relevant entities' income, and if so, which one?

An added dimension to the jurisdictional issue is motivation for transfer pricing manipulation as some MNEs engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through non-arm's length transfer pricing in order to reduce the aggregate tax

burden of a multinational group. It may be noted that the reduction of taxation may be a motive influencing an international enterprise in the setting of transfer prices for intra-group transactions, but it is not the only factor contributing to the transfer pricing policies and practices of an international enterprise.

The aim of non-arm's length transfer pricing in such cases is usually to reduce a multinational group's worldwide taxation. This can be achieved by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under-charging or over- charging the associated entity for intra-group trade. For example, if a company (Co. 1) an international MNE group has a tax rate in a country of 30% (such as the tax rate in Timor-Leste) and it has a related entity (Co. 2) resident in another country with a tax rate of 20%, then Co.1 may have an incentive to shift profits to its related entity (Co. 2) to reduce its tax rate on these amounts from 30% to 20%. This may be achieved by the Co. 1 (the one deriving significant income in Timor-Leste) being over-charged for the acquisition of property and services from its related entity (Co. 2).

While the most obvious motivation may be to reduce an international enterprise's worldwide taxation, other factors may influence transfer pricing decisions, such as imputation of tax benefits in a company's country of residence.

A further motivation for an international enterprise to engage in such practices is to use a tax benefit, such as a tax loss, in a jurisdiction in which it operates. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. In some cases an international enterprise may wish to take advantage of an associated company's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying forward tax losses by an associated company, the international enterprise has an incentive to use the losses as quickly as possible. In other words profits may sometimes be shifted to certain countries in order to obtain specific tax benefits.

From the perspective of Timor-Leste, similar to other taxing jurisdictions, the allocation of

costs and income from the MNE resources need to be addressed to calculate the appropriate taxes due. It is not uncommon, and this reality is certainly recognized by the government of Timor-Leste, that there sometimes can be disputes between countries in the allocation of costs and resources owing to their objective of maximising the tax base in their respective nation states.

Mere allocation of income and expenses to one or more members of the MNE group is not sufficient; the income and expenses must also be *valued*; a key issue of transfer pricing is therefore the valuation of intra-group transfers.

With the MNE being an integrated structure with the ability to exploit international differentials and to utilise economies of integration not available to a stand-alone entity, transfer prices within the group are unlikely to be the same prices that unrelated parties would negotiate.

Therefore, transfer pricing rules are essential for countries, including the tax regime of Timor-Leste, in order to protect their tax base, to eliminate double taxation and to enhance cross border trade. For Timor-Leste, transfer pricing rules are essential to provide a climate of certainty and an environment for increased cross-border transactions with other countries, while at the same time ensuring that the Timor-Leste tax administration is not deprived of its fair share of tax revenue.

Use of the "arm's length principle" under Timor-Leste TDA Regulations

Consistent with the approaches adopted by the OECD, the United Nations, and most other tax jurisdictions, the Timor-Leste government, as reflected in the TDA Regulations, uses the "arm's length principle" as the guiding principle in establishing an acceptable "transfer price" between associated enterprises.

Under the arm's length principle, transactions within a group are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices. Thus, the marketplace comprising independent entities is the measure or benchmark for verifying the transfer prices for intra-entity or intra-group transactions and their acceptability for taxation purposes.

The rationale for the arm's length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities. Under the arm's length principle, intra-group transactions are tested and may be adjusted if the transfer prices are found to deviate from comparable arm's length transactions.

An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in a similar manner. However this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may be provided with an incentive to avoid taxation through transfer pricing manipulation.

While it is relatively easy to describe the arm's length principle, establishing guidelines on the practical application of the principle is a complex task as its practical application requires identification and application of reliable comparable transactions.

The following example describes a situation where the arm's length principle needs to be applied:

- Assume a corporation P (parent) manufactures diamond drill bits (for oil wells operations) in country A, sells the finished drill bits to its subsidiary S in country B which then uses the drill bits in providing services to unrelated parties. In such a case S's taxable profits are determined by the depreciation taken of the drill bits to the unrelated parties, based on the purchase price paid for the drill bits to its parent corporation.

If country A where the drills are manufactured has a tax rate lower than the tax rate in country B where the drill bits are being used for services to unrelated parties, then perhaps corporation P would have an incentive to book as much profit as possible in country A and to this end show a very high sales value (or transfer price) of the drill bits to its subsidiary S in country B.

On the other hand, If the tax rate was higher in country A than in country B then the corporation would have an incentive to show a very low sale value (or transfer price) of the drill bits to its subsidiary S in country B and concentrate almost the entire profit in the hands of country B.

The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case corporation P and its subsidiary S) are appropriately priced to reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

The underlying concept for the arm's length principle is to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create.

Applying the arm's length principle

The process to arrive at the appropriate arm's length price typically involves the following processes or steps:

a) Comparability analysis;
b) Evaluation of transactions;
c) Evaluation of separate and combined transactions;
d) Use of an arm's length range or central point in the range;
e) Use of multiple year data;
f) Losses;
g) Location savings and location rents;
h) Intentional set-offs; and
i) Use of customs valuation.

Definition of "Associates" / "related parties" under TDA Regulations

The term "Associate" has the following definition under Section 4 of the TDA Regulations:
"Associate" in relation to a person means any other person who acts or is likely to act in accordance with the wishes of the person as a result of a connection between the persons or common ownership or control; it includes:

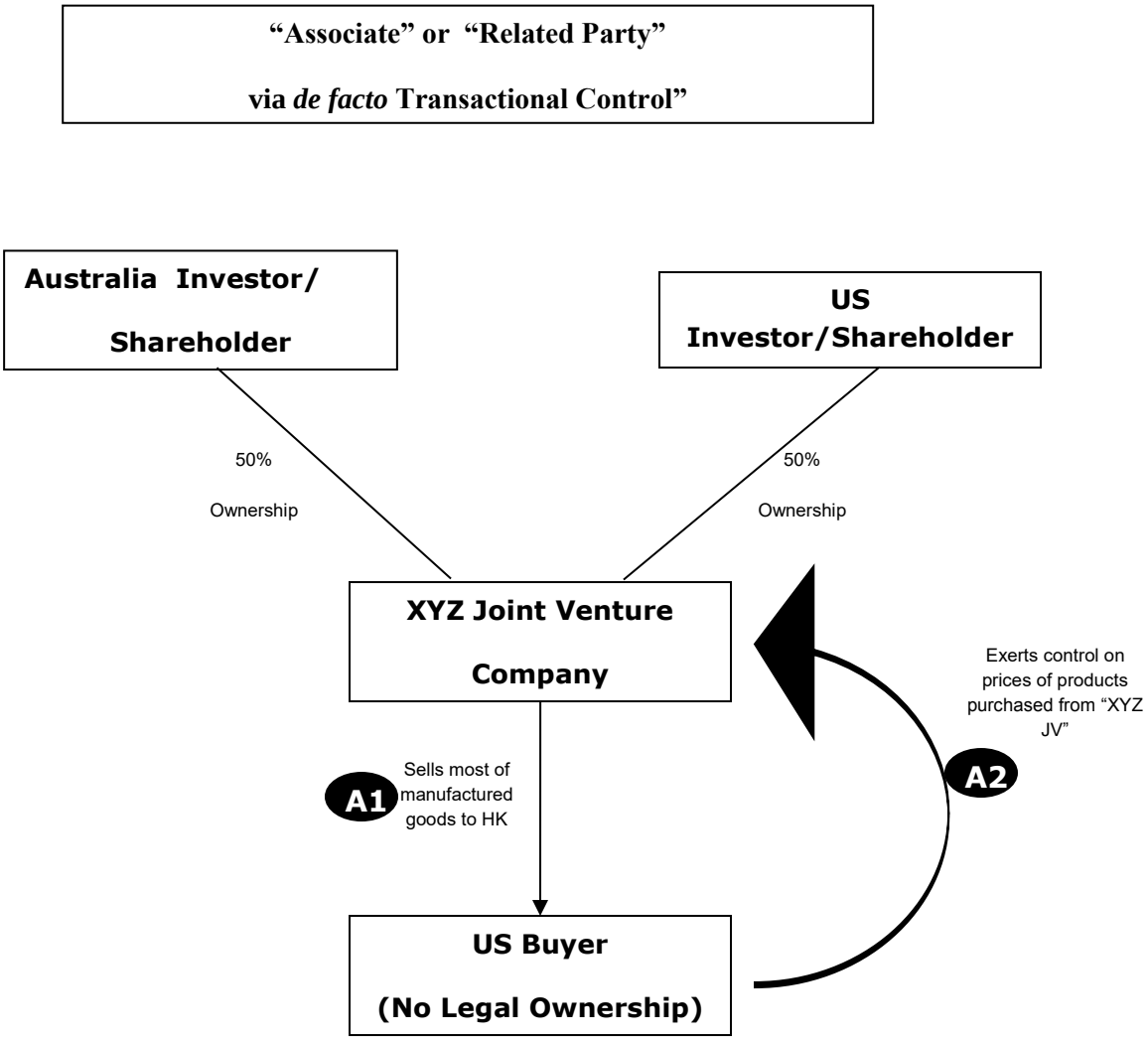
a) A natural person and a relative of the natural person;

b) A legal person and any person who owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in the legal person; or

c) Two or more legal person if a third owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in each person;

It should be noted that even if two persons, such as two corporations, are not under the direct or indirect common control or 50% or more of their capital or voting rights are owned by one entity, they can still be considered as "associates" or "related parties" for purposes of the TDA Regulations if one party has *de facto* control of another party i.e. if one party will likely to act in accordance with the wishes of the other party. This type of *de facto* control can be illustrated by the example below (next page).

Example



A1	:	XYZ JV sells most of its products to US buyer.
A2	:	US Buyer exerts effective control over prices charged by XYZ JV on products sold to buyer.
Result	:	XYZ JV and US buyer can be considered "related parties" even though there is no legal ownership between them.

Section 22
Transfer Pricing Methods in Connection with Transfer of Tangible and Intangible Properties

This part of the TDA Regulations describes several transfer pricing methods that can be used to determine an arm's length price and describes how to apply these methods in practice. Transfer pricing methods or methodologies are used to calculate or test the arm's length nature of prices or profits. Transfer pricing methods are ways of establishing arm's length prices or profits from transactions between associated enterprises. The transaction between related enterprises for which an arm's length price is to be established is referred to as the controlled transaction. The application of transfer pricing methods helps assure that transactions conform to the arm's length standard. It is important to note that although the term "profit margin" is used, companies may also have legitimate reasons to report losses at arm's length. Furthermore, transfer pricing methods are not determinative in and of themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the recognized transfer pricing methods, this does not mean that its pricing should automatically be regarded as not arm's length and there may be no reason to impose adjustments.

Transfer Pricing Methods Overview

The key question is how to apply the arm's length principle in practice to determine the arm's length price of a transaction. Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

All these transfer pricing methods rely directly or indirectly on the comparable profit, price or margin information of similar transactions. This information may be an "internal comparable" based on similar uncontrolled transactions between the entity and a third party or an "external comparable" involving independent enterprises in the same market or industry.

There are five (5) transfer pricing methods as indicated under the TDA Regulations. These five transfer pricing methods are also recognized by the OECD and the United Nations in their

respective guides to transfer pricing. The methods can be divided into two major categories: (a) transaction based methods and (b) profit-based methods.

Transaction based methods

Comparable Uncontrolled Price (CUP)

The CUP method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances.

Resale Price Method (RPM)

The resale price method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by the reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

Cost Plus Method

The cost plus method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs incurred by the supplier an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions performed.

Profit-based methods

Two major classes of transactional profit methods are currently in use, as recognised by the USA and the OECD Guidelines. These may be categorised as profit-comparison methods (Transactional Net Margin Method or TNMM / Comparable Profits Method or CPM) and profit-split methods (PSM).

Comparable Profit Methods

This is a type of profit comparison methods (TNMM/CPM). These methods seek to determine the level of profits that would have resulted from controlled transactions by reference to the return realised by the comparable independent enterprise. The TNNM determines the net profit

margin relative to an appropriate base realised from the controlled transactions by reference to the net profit margin relative to the same appropriate base realised from uncontrolled transactions.

Profit-split methods ("PSM")

Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm's length. Arm's length pricing is therefore derived for both parties by working back from profit to price.

The first three methods above i.e. CUP, RPM and Cost Plus are often called "traditional transaction" methods and the last two are called "transactional profit methods" or "profit-based" methods.

Other unspecified methods

Other unspecified methods may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any such method should be applied in accordance with the reliability considerations used to apply the specified methods described above. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. In establishing whether a controlled transaction achieves an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.

Selection of the Transfer Pricing Method under the TDA Regulations

Method selection - need for functional analysis

The selection of a transfer pricing method serves to find the most appropriate method for a particular case. Considerations involved in selecting a method can include the respective strengths and weaknesses of each method; the nature of the controlled transaction; the

availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions. The starting point in selecting a method is an understanding of the controlled transaction (inbound or outbound), in particular based on the functional analysis which is necessary regardless of which transfer pricing method is selected.

Functional analysis is a major part of selecting the transfer pricing method as it achieves the following objectives:

- to identify and understand the intra-group transactions;
- to identify the characteristics that would make a particular transaction or function suitable for use as a comparable;
- to determine any necessary adjustments to the comparables;
- to check the relative reliability of the method selected; and
- over time, to determine if modification of the method is appropriate because the transaction, function, allocation of risks or allocation of assets have been modified.

The major components of a functional analysis are analyses of the functions, assets and risks. A summary approach is provided here for context in the case of selection of appropriate methods.

The functions performed:

The functional analysis describes the activities performed such as design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inventory management, outbound logistics, marketing and sales activities, after-sale services, supporting activities, services, advertising, financing and management, etc. The functional analysis must specify which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences

For example the two related companies, A and B, both have inventories but Company A holds inventories for a period of up to 2 years whereas company B only holds inventories for a period of 1 month. The activities that add most value must be identified and should be discussed in more detail.

The risks undertaken:

The functional analysis should identify risk undertaken. Examples are: financial risk (currency, interest rate, funding risks etc…), credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk), commodity price risk, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks, market risk (country political risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs and contract enforceability). A risk-bearing party would expect to have higher earnings than a non-risk bearing party, and will incur the expenses and perhaps related loss if and when risk materializes.

The assets used or contributed:

The functional analysis must identify and distinguish between tangible and intangible assets. Tangible assets such as property, plant and equipment have to be financed and an investment in such capital assets would usually be expected to earn a long term return based on the use and risk level of the investment. Intangible assets are very important as substantial competitive advantage is often achieved by the use of intangible assets. Some intangibles have legal protection (e.g. patents, trademarks, trade names) but other intangibles with less legal protection may be equally important and valuable (e.g. know-how, trade secrets, marketing intangibles, etc.).

Interplay of above factors:

Within a multinational group, operations tend to be more integrated across jurisdictional boundaries and the functions, risks and assets are often shared between entities in different jurisdictions. The functional analysis can help identify which functions, risks and assets are attributable to the various related parties. For example, the functional analysis may reveal that one company performs one particular function but the cost thereof is borne by the other party to the transaction. The functional analysis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. There could be another example where one company performs one particular function and bears the cost thereof but the benefit is also accrued to the other party to the transaction.

The functional analysis could emphasize that situation and consider which party bears the risk in legal terms and which party bears the risk according to the economic substance of the transaction. The functional analysis typically includes a discussion of the industry in which the tested party operates, the contractual terms of the transaction at issue, the economic circumstances of the parties and the business strategies they employ. The functional analysis helps to identify the operations that benefit a related party and so require an arm's length return.

Selecting a method after the functional analysis:

Once the functional analysis is performed the application of a transfer pricing method, with the associated evaluation of comparable transactions may be considered. Transfer pricing methods typically use information on comparables, and the lack of such comparables can make a particular method – even one that might seem initially preferred – inapplicable, and a different method more reliable. These comparable transactions are also referred to as uncontrolled transactions because the parties involved in the transactions are independent of each other.

Once a method is chosen and applied, the taxpayers are expected to apply the method in a consistent fashion. Assuming that an appropriate transfer pricing method is being applied, a change in method is typically required only if there are any changes in the facts, functionalities or availability of data.

Section 22.1(c)

Comparable Uncontrolled Price Method ("CUP")

The CUP method determines whether the amount charged as between "associates" or "related parties" is arm's length by looking at the amount in a comparable uncontrolled (i.e. between unrelated companies) situation. If the comparability requirement is met, then the CUP method is usually the most reliable and direct way of arriving at an arm's length price.

For the CUP method to be used, there must be available "comparable transactions." In the situation of a particular set of related companies, the CUP may be used, for example, where a

company also sells the same products (as the ones sold to the related company) to other unrelated customers.

When applying the CUP method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences in the transactions being compared that would materially affect the price; or
- Reasonably accurate adjustments can be performed to account for material differences between the controlled and the uncontrolled transaction.

In performing the comparability analysis the controlled transactions and uncontrolled transactions should be compared based on the comparability factors. In determining the degree of comparability between the controlled transactions and uncontrolled transaction , typically the following factors should be taken into account: (i) characteristics of property being transferred or services provided, (ii) contractual terms, (iii) economic circumstances and (iv) business strategies.
For the functional analysis it is necessary to analyze the functions performed, the risks assumed and the assets used.

Product comparability should be closely examined in applying the CUP method. A price may be materially influenced by differences between the goods or services transferred in the controlled and uncontrolled transactions. The CUP method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.

Although product comparability is important in applying the CUP method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are also important comparability factors. Where there are differences between controlled and uncontrolled transactions, adjustments should be made to enhance reliability.

Reasonably accurate adjustments may be possible for differences in:

- The type and quality of the products (e.g. unbranded coffee beans from Kenya as compared with unbranded coffee beans from Brazil);
- Delivery terms. E.g. Associated Enterprise 1 in the diagram illustration sells similar bicycles to Associated Enterprise 2 and an Unrelated Party.

All relevant information on the controlled and uncontrolled transactions is available to Associated Enterprise 1, and hence it is probable that all material differences between the transactions can be recognized. The uncontrolled price can be adjusted for the difference in delivery terms to eliminate the effect of this difference on the price.

- Volume of sales and related discounts. E.g. Associated Enterprise 1 sells 5000 bicycles to Associated Enterprise 2 for US$90 per bicycle, while it sells 1000 similar bicycles to an unrelated party. The effect of the differences in volume on price should be analyzed, and if the effect is material adjustments should be made based, perhaps, on volume discounts in similar markets)

- Product characteristics. E.g. the uncontrolled transactions to an Unrelated Party involve bicycles on which modifications have been made. However, the bicycles sold in the controlled transactions do not include these modifications. If the product modifications have a material effect on price, then the uncontrolled price should be adjusted to take into account this difference in price);

- Contractual terms. Associated Enterprise 1 sells the bicycles to Associated Enterprise 2 offering a 90 day credit term but the contract terms dictate that all sales to Unrelated Party are Cash On Delivery;

- Risk incurred. E.g. Associated Enterprise 1 is exposed to inventory risk related to sales by Associated Enterprise 2 and the risk that customers of Associated Enterprise 2 will default on their bicycle purchase loans; whereas in the transaction between Associated Enterprise 1 and Unrelated Party, the Unrelated Party is exposed to the inventory risk and

the risk of its customers' default. This difference in risk allocation must be analyzed and its effect on price quantified before Associated Party 2's prices and Unrelated Party's prices can be considered comparable;

- Effects of geographical differences. E.g. Associated Enterprise 1 sells bicycles to Associated Enterprise 2 located in South Africa, while an Unrelated Party to which it also sells the same bicycles is located in Egypt. The only material difference that could be identified between the controlled and uncontrolled transactions concerns the locale. To perform adjustments to account for this difference one might have to consider, for example, differences in inflation rates between South Africa and Egypt, the competitiveness of the bicycle market in the two countries and differences in government regulations if relevant);

It is assumed that the circumstances relating to the controlled and uncontrolled transactions are similar. The only material difference that could be identified between the transactions is that the price relating to the controlled transaction is a delivered price (i.e. including transportation and insurance), while the uncontrolled transaction # 1 is made ex works, with the buyer taking responsibility from the named place of delivery, which is Associated Enterprise 1's factory. It is possible to perform reasonably accurate adjustments for this difference.
All figures and numeric examples are for practical purposes only. They do not reflect actual cases or actual arm's length figures or margins

Reasonably accurate adjustment may not be possible for:

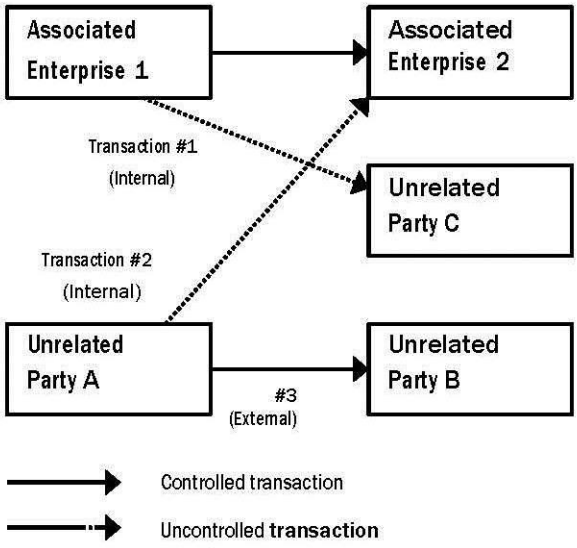
- Unique and valuable trademarks (e.g. assuming Associated Enterprise 1 in the diagram is engaged in high value branded goods, e.g. watches instead of bicycles, and attaches its valuable trademark to the goods transferred in the controlled transaction, while uncontrolled transaction #1 concerns the transfer of goods that are not branded . The effect of the trademark on the price of a watch may be material. However it will be difficult, if not impossible, to adjust for effect of the trademark on price since the trademark is an intangible asset that is unique. If reasonably accurate adjustments cannot

be made to account for a material product difference the CUP method may not be the appropriate method for the transaction); and

- Fundamental differences in the products (e.g. if the products being sold are significantly different from the products sold in the proposed comparable transaction it may not be possible to adjust for the product differences).

Notwithstanding the difficulties often associated with adjustments to address the sources of non- comparability described above, the need to make adjustments should not automatically prevent the use of the CUP method. It is often possible to perform reasonably accurate adjustments. If reasonable adjustments cannot be performed the reliability of the CUP method is decreased. In these circumstances another transfer pricing method may be more appropriate.

Comparable Uncontrolled Price (CUP) Method - Illustration



Example 1 (Use of the CUP method)

Charlie Sub (CS) manufactures Toy Cars and sells 800,000 items to unrelated customers in Country K for $ 2.20 each. CS will also be selling 800,000 items of Toy Cars to its 75% shareholder company (B), in Hong Kong. With other things being equal, the $ 2.20 per unit price

which CS sells to its unrelated Country K customers should be the arm's length transfer price used by CS when selling to B, a related company.

The method as described in Example 1 above is commonly referred to as "Internal CUP".

When there are no "internal comparables" (Internal CUP) as in the example above, one must determine whether External CUP (or "external comparables") is available. In other words, if an company sells all its products to a related company, but not to an unrelated customers, then the taxpayers and the tax authorities would need to find comparables from outside the related companies in question. The reality of the market place is that no two sales are exactly the same. External CUP is feasible if similar products can be found and which are sold under terms/conditions which are sufficiently similar. If there are differences in product specifications or the conditions of sale, those differences are of a nature that they can be measured and adjusted for. However, if the products or sales conditions differ in material respects so that the differences cannot be quantified and adjusted for in a reasonable manner, then the CUP method should not be used.

Example 2 (Use of the CUP method)

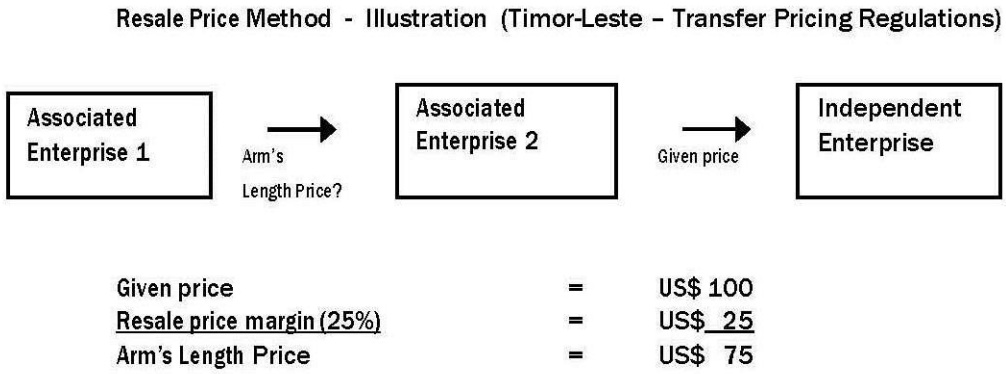
ABC, a Country J manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. ABC's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. Because ABC sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this

application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result

22.1(d)

Resale Price Method (RPM)

The second transfer pricing method specified by the TDA Regulations is the Resale Price Method (RPM).



The resale price method is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The resale price method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis. This is depicted in the diagram above.

All figures used in this and subsequent examples, such as gross margins and net margins, are for illustrative purposes only. They do not reflect actual cases or actual arm's length figure or margins, but are used for ease of calculation

Application of the Resale Price Method. The resale price method analyzes the price of a product that a related sales company (i.e. Associated Enterprise 2 in above diagram) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the

sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs and the risks it incurs. The remainder of the product's price is regarded as the arm's length price for the intercompany transactions between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1). As the method is based on arm's length gross profits rather than directly determining arm's length prices (as with the CUP method) the resale price method requires less direct transactional (product) comparability than the CUP method.

Consequently, under the resale price method the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1) can be described in the following formula:

TP = RSP x (1-GPM), where:

• TP = the Transfer Price of a product sold between a sales company and a related company;

• RSP = the Resale Price at which a product is sold by a sales company to unrelated customers; and

• GPM = the Gross Profit Margin that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold.

Example: It is assumed that the resale price in the above diagram is $100. This means that Associated Enterprise 2 resells the bicycle to Independent Enterprise for $100. If we assume that an arm's length gross profit margin that Associated Enterprise 2 should earn is 25%, Associated Enterprise 2 should cover its SG&A expenses and make an appropriate profit with this 25% gross margin. The resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 (i.e. the cost of goods sold of Associated Enterprise 2) is $75 (i.e. $100 x (1-0.25).

Other approaches are possible. For example, if the associated enterprise acts as a sales agent that does not take title to the goods, it is possible to use the commission earned by the sales agent represented as a percentage of the uncontrolled sales price of the goods concerned as the

comparable gross profit margin. The resale price margin for a reseller should always be determined by taking into account the functions performed, assets used and risks assumed by the reseller.

Arm's Length Gross Profit Margin:

The financial ratio analyzed under the resale price method is the gross profit margin. Gross profit is defined as net sales minus cost of goods sold. It is easiest to determine where the reseller does not add substantially to the value of the product. The net sales of a sales company are the sales revenue obtained by selling products to unrelated customers, while the cost of goods sold equals the cost of purchasing the goods sold plus certain additional non-operating costs. Thus, if we are determining the gross margin for products purchased from a related company the cost of goods sold will include the transfer price paid to the related manufacturer.

Accounting consistency is extremely important in applying the resale price method. Gross profit margins will not be comparable if accounting principles and/or practices differ between the controlled transaction and the uncontrolled transaction. For example, the comparable distributors may differ from the related sales company in reporting certain costs (e.g. discounts, transportation costs, insurance and costs of performing the warranty function) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the gross margins. It is thus important that the analysis does not compare "apples with oranges" but rather, "apples with apples". Therefore, appropriate adjustments should be applied to the data used in computing the gross margin to make sure that 'similar' gross margins are compared.

Transactional comparison versus functional comparison:

The arm's length price or margin can result from looking at comparable functionality (distributors of broadly similar types of product) or from making a transactional comparison by looking at each transaction the tested party engages in involving comparable products (i.e. sales of different types of bicycles).

The arm's length (range of) gross profit margin(s) to be earned by the sales company in the controlled transaction can therefore be determined in the following two ways:

- By transactional comparison: For example, one could determine the gross profit margin that Associated Enterprise 2 earns when reselling bicycles purchased from an independent manufacturer in comparable uncontrolled transaction. This uncontrolled transaction may initially have been rejected as an internal comparable for purposes of applying the CUP method because, for example, the transaction involves a different type of bicycle. If the sale of recreational bicycles is at issue, but the unrelated transactions involve rickshaws, taxi bikes this may involve broadly similar products with comparable accounting measures of Costs of Goods Sold (COGS) making gross margin comparisons sufficiently reliable; and
- By functional comparison: the gross profit margins earned by independent companies in comparable uncontrolled transactions performing functions and incurring risks comparable to the functions performed and risks incurred by Associated Enterprise 2. Functional comparison thus involves a search for comparable distribution companies rather than comparable transactions. This could, for example, include comparable distributors of wheelbarrows and carts.

In practice transactional comparisons are more likely to achieve broad product and accounting consistency than functional comparisons. This means that it is sometimes not necessary to conduct a resale price analysis for each individual product line distributed by a sales company under this method. Instead, the resale price method is used in those situations to determine the gross margin a sales company should earn over its full range of (aggregated) products.

Comparability in applying the resale price method,
An uncontrolled transaction is considered comparable to a controlled transaction if:

- there are no differences between the transactions being compared that materially affect the gross margin (for example, contractual terms, freight terms, etc.); or
- reasonably accurate adjustments can be performed to eliminate the effect of such differences.

As noted above, the resale price method is more typically applied on a functional than on a transactional basis so functional comparability is typically more important than product comparability. Product differences will probably be less critical for the resale price method applied on a functional basis than for the CUP method, because it is less probable that product differences will have a material effect on profit margins than on price. One would expect a similar level of compensation for performing similar functions across different activities.

While product differences may be more acceptable in applying the resale price method as compared to the CUP Method, the property transferred should still be broadly similar in the controlled and uncontrolled transactions. Broad differences are likely to reflect differences in functions performed, and therefore gross margins earned, at arm's length.

Example: The compensation for a distribution company should be the same whether it sells washing machines or dryers, because the functions performed (including risks assumed and assets used) are similar for the two activities. The price of a washing machine will, of course, differ from the price of a dryer, as the two products are not substitutes for each other. Although product comparability is less important under the resale price method, greater product similarity is likely to provide more reliable transfer pricing results. It is not always necessary to conduct a resale price analysis for each individual product line distributed by the sales company. Instead, the resale price method can be applied more broadly, for example based on the gross margin a sales company should earn over its full range of broadly similar products.

As the gross profit margin remunerates a sales company for performing marketing and selling functions, the resale price method especially depends on comparability regarding functions performed, risks assumed and assets used. The resale price method thus focuses on functional comparability. A similar level of compensation is expected for performing similar functions across different activities. If there are material differences that affect the gross margins earned in the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. In general comparability adjustments should be performed on the gross profit margins of the uncontrolled transactions.

The operating expenses in connection with the functions performed and risks incurred should be taken into account in this respect as differences in functions performed are frequently reflected in different operating expenses.

The following issues should be considered in determining whether the functions performed by an uncontrolled entity are comparable to the functions performed by a controlled entity for purposes of applying the resale price method:

- In contrast to the CUP method, the reliability of the resale price method can be influenced by factors that have less effect on the price of a product than on the costs of performing functions. Such differences could affect gross margins even if they do not affect the arm's length prices of products (e.g. the composition of COGS). These factors could include cost structures (e.g. accounting practices), business experience (e.g. start-up phase or mature business) or management efficiency;
- A resale price margin requires particular attention where the reseller adds substantially to the value of the product, for example by assisting considerably in the creation or maintenance of intangible property related to the product (e.g. trademarks or trade names) or where goods are further processed into a more complicated product by the reseller before resale);
- The amount of the resale price margin will be affected by the level of activities performed by the reseller. For example, the distribution services provided by a reseller acting as a sales agent will be less extensive than those provided by a reseller acting as a buy-sell distributor. The buy-sell distributor will obviously obtain a higher compensation than the sales agent;
- If the reseller performs a significant commercial activity in relation to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangibles of the reseller), it may earn a higher gross profit margin;
- The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin;

- The analysis should consider differences in accounting practices that apply to the reseller and to comparable companies in order to make appropriate adjustments to enhance comparability;
- The reliability of the analysis will be affected by differences in the value of the products distributed, for example, as a result of a valuable trademark.

It should be recognized that returns to similar functions may not be the same in different markets. Generally, reliability is enhanced when the reseller and the comparable companies are operating in the same market

The RPM method examines whether the amount charged by an company to a related company is "arm's length" by looking at the "gross profit margin" realized in comparable uncontrolled transactions. The RPM re-computes an arm's length price for the products being sold by subtracting the comparable gross profit margin of comparable unrelated sellers (distributors) from the resale price of the related buyer (i.e. the related company buying from the related seller, and which in turn resells the products).

In applying the RPM, the comparable sale (i.e. data from comparable but unrelated resellers, distributors, etc.) does not have to pertain to identical products. Rather, the RPM aims to provide compensation to the reseller for its resale functions in connection with the product(s) being examined, including an operating profit in return for investment of capital and the assumption of risks. In other words, the arm's length transfer prices are calculated in such a way so as to reflect the similar gross profit ratio as that of an independent, unrelated reseller. The underlying concept is that the unrelated reseller will price its goods to realize a gross profit margin to cover operating expenses, plus a reasonable profit, based on marketplace realities. The gross profit element here equals the value of the resale or distribution functions.

Similar to the CUP method, use of the RPM needs a degree of comparability between the related and unrelated transactions. In contrast to the CUP method, similarity of the physical attributes of the goods/products involved are not important. Rather, the focus on comparability for purposes

of the RPM are the resale functions, and the factors affecting the management of and distribution of the products.

The following table lists the typical factors (which are considered as significant in finding comparables of gross profit percentage in RPM:

Factors Relevant to Comparability of Gross Profit Ratios
1. Similarity of functions between resellers
2. Risk distribution as between manufacturer and reseller
3. Terms of sale – contractual terms
4. Management efficiency of reseller
5. Whether intangibles exist for products
6. Level of market – wholesale, retail
7. Sales function, such as advertising, marketing, etc.
8. Cost structures comparison of the resellers

To apply RPM correctly to transactions between related companies, a detailed functional analysis must be performed, so as to take into account factors, such as the ones listed above.

A significant conceptual difference between RPM and CUP is that RPM is concerned with only one side of the transaction. In essence, RPM "fixes" the gross profit of the related company which is the "reseller", according to a "norm" obtained from comparable unrelated resellers. This means that if the "related company reseller" performs above or below this "norm", the effect on profit will be absorbed by the other related company – the manufacturer. Given the situation, the RPM can be used as a tax planning technique – allowing a multinational company to shift profits away from a "related company reseller".

The RPM:

1. starts with the "ending sales price" of the "related company reseller" to unrelated

customers.

2. based on comparable unrelated resellers and distributors, computes a "comparable gross profit ratio"
3. using the "comparable gross profit ratio" in 2. above, applies it to the "ending sales price" in 1.above, to determine the "related company reseller" 's "gross profit"
4. subtracting the "gross profit" as determined in 3. above from the "ending sales price" in 1. will yield the "arm's length sale price" from the "related company manufacturer (seller)" to the "related company reseller".
5. as a result, all residual profit is allocated to the "related company manufacturer (seller) due to the "arm's length sale price" result in 4. above.

The RPM can also expressed in formula form as follows:

Arm's Length Price = [Resale Price – (Comparable Gross Profit %* x Resale Price)]

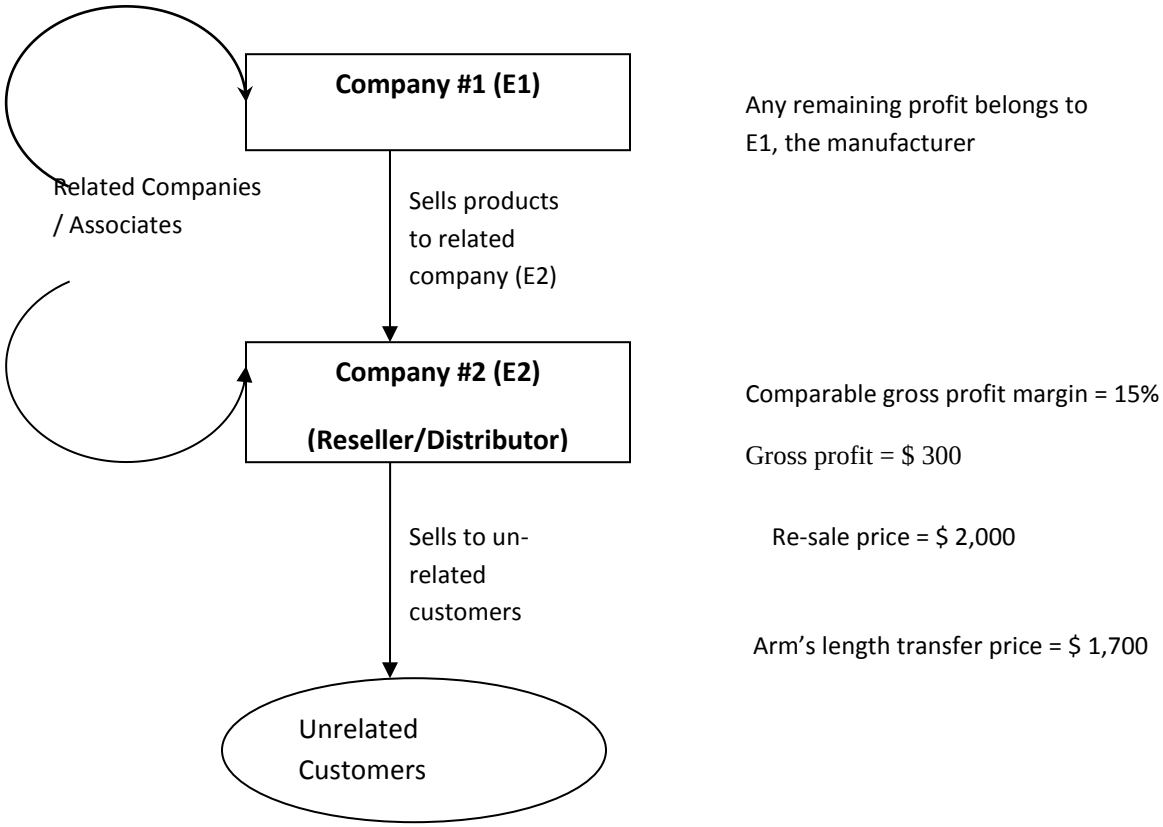
* Comparable Gross Profit % derived from unrelated resellers / distributors after performing detailed functional analyses.

Example 1 (use of the Resale Price Method)

A company sells property to an associate company (member of its controlled group) that resells the property in uncontrolled sales (i.e. sales to unrelated parties). There are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions (i.e. sales to unrelated parties) have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale is a price of $80 ($100 minus (20%×$100)).

The diagram below illustrates how the RPM method works.

Diagram # ___ : Illustration of the Resale Price Method (RPM)



22.1 (e)
Cost Plus Method

The third transfer pricing method specified under the TDA Regulations is the cost plus method. Under the Cost Plus Method, the arm's length transfer price is derived by adding a "gross profit markup" to the selling company's cost of goods sold. The "gross profit markup" is obtained by comparing the related entities' transaction with transactions as between unrelated companies.

The amount of the "gross profit markup" is dependent on a variety of factors, such as: functions performed by the selling company (manufacturer), the sale transaction terms (i.e. contract terms), risks distribution as between the selling company and the buying company. Therefore, the relative size of the "gross profit markup" is usually higher for those seller / manufacturers which engage in the full range of manufacturing function, versus those seller/manufacturers which perform a simpler "contract manufacturing" function.

Similar to the Resale Price Method (RPM), the Cost Plus Method determines an arm's length price by basing it on an assumed gross profit. In contrast to the RPM method however, the Cost Plus Method sets the gross profit of the seller/manufacturer. (In the RPM case, it is the buyer / reseller's profit which is being determined.)

In calculating the transfer price for related companies, the "gross profit markup" is added to the manufacturing costs of the selling company (i.e. the seller / manufacturer), plus other normal costs, such as freight, insurance and customs duties.

An example of the Cost Plus Method computation is as follows:

Cost of sales (production / manufacturing expenses)	=	$ 5,000	
Gross Profit Markup (20%)		=	1,000
Other costs (such as transportation, etc.)	=	300	
Arm's Length Transfer Price	=	$ 6,300	

Similar to the RPM method, the Cost Plus Method looks at only one side of a related company's transaction. Starting with the related selling company (typically the manufacturer)'s production/manufacturing costs, it computes a "gross profit markup" using data from comparable manufacturers / sellers in unrelated situations. That "gross profit markup" (also referred to as "gross profit margin") is applied to the selling company (manufacturer)'s costs. The selling company's profit level is then set. As a result, all remaining profits belong to the buying company (i.e. the related company buying from the selling/manufacturer company).

The practical effect of the Cost Plus Method is that it allocates only the "normal" or "typical" profit to the company which is the manufacturer / seller, so that above normal profits are shifted to the buying company (i.e. the reseller), or if profits are below normal (or for overall loss years), a smaller portion of profits are given to the buying company (the reseller), while the profit to the manufacturer / seller more or less holds steady.

The correct use of the Cost Plus Method is based on the "comparability" of an array of factors between the "related companies" transactions and the "unrelated companies" transactions. For example, if a manufacturing company in the "related" situation perform only the task of assembling the components together, and no more, then in the "unrelated" situation (from which the "gross profit markup" is obtained) the manufacturing company should also only do the assembling function.

On the other hand, if the manufacturing company in the "related" situation also performs "designing" and "testing" functions in addition to the "assembling" function, then adjustments should be made to the "gross profit markup" to compensate for the differences in function. In this example, the "gross profit markup" of the "unrelated" situation has to be reduced before it can be used in the "related" situation, to account for the lesser functions being performed by the manufacturing company in the "related" situation.

Factors which should be considered in formulating a transfer price under the Cost Plus Method include the following:

- Degree of complexity in the production and assembly process
- Purchasing, inventory management function
- Testing of products function
- Design of products function
- Sales terms and conditions (including credit terms, risks assumption, warranty provided, etc.

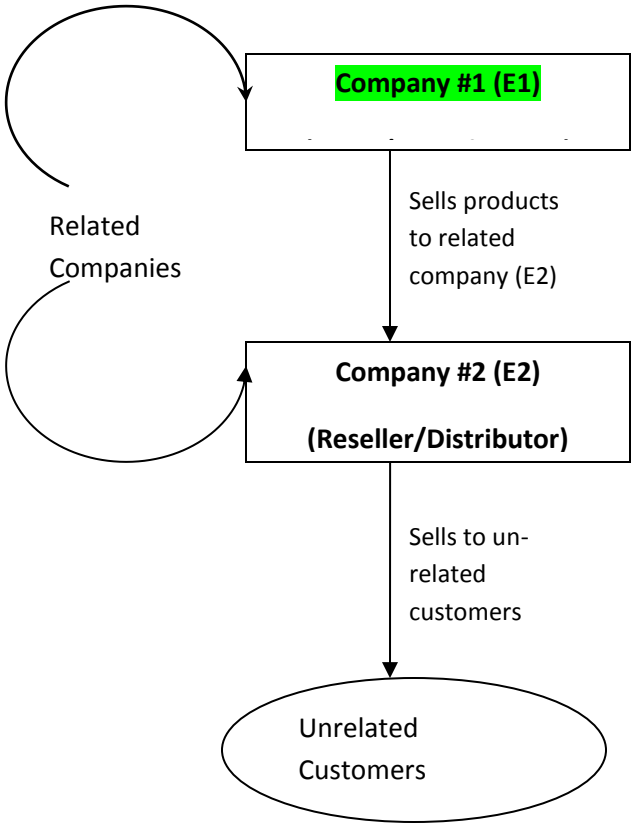
Example (use of the Cost Plus Method)

R Company, a manufacturer of computer components, sells its products to S, its distributor. T1, T2, and T3 are computer component manufacturers that sell to uncontrolled (unrelated) purchasers.

Relatively complete data is available regarding the functions performed and risks borne by T1, T2, and T3, and the contractual terms in the uncontrolled transactions (i.e. transactions with unrelated parties).

In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and R. Because the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions (i.e. transactions with unrelated parties) have been identified, the effect of the differences are definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established .

Illustration of Cost Plus Method



Manufacturing /production cost =RMB 5,000

Gross profit mark up % = 20%

(based on comparable)

Gross profit = RMB 1,000

Arm's length transfer price = RMB 6,300

Any remaining profit belongs to E2, the Reseller/Distributor

Re-sale price = Not relevant in Cost Plus Method

22.1(f)
Comparable Profit Method (CPM)

The CPM concept is to determine whether the amount charged by a company to a related company is at arm's length, based on a "profit level" for comparable situations involving "unrelated companies". The "profit level" which the CPM tries to emulate is the "operating profit" of a company.

As there are at least two (2) companies involved in a transfer pricing for "related companies", a threshold issue is which one of the two companies should be the "tested" party, for the "profit level" to be applied to. In general, the "tested party" is the one with the less complicated functions, and which likely do not own intangible assets.

As in the case of the CUP (Comparable Uncontrolled Price) Method, the proper use of CPM is dependent upon the availability of data from uncontrolled situations (unrelated companies). At present, there is still a general lack of such database availability.

After identifying as to which of the related companies should be the "tested party", the next inquiry is what should be the "profit level indicator (PLI)". This can vary substantially depending on the type of business and function which the company is engaged in. For example, for manufacturing concerns, use of "return on assets" is acknowledged to be an appropriate PLI.

Generally, PLIs should be based on more than one year of operations. This is necessary to avoid extreme fluctuations occurring in a particular year. In practice, at least three (3) years of operations are used.

Correct selection of comparables is a significant part of using the CPM. Detailed functional analysis must be performed on the "tested company" of the related companies, and compare the functions to those from the "unrelated companies" data pool.

22.1(g)

Comparable Profit Split Method

The Profit Split Method takes the "combined operating profit or loss" of the "related companies", and allocates (splits) that profit (or loss) among the two related companies, taking into account the relative contribution made by each company towards generating that profit. The allocation is to be made based on comparable ratios derived from uncontrolled situations (involving unrelated companies) where the parties perform the similar degrees of function as in the case of the "related companies".

There are two major types of Profit Split Method: a. the Comparable Profit Split Method (also referred to as "contribution analysis"), and b. the Residual Profit Split Method, which is discussed in the section below.

Under the Comparable Profit Split Method, the inquiry starts by determining the combined operating profit of unrelated companies, which perform the same relative functions as those in the "related companies" situation being examined. Using the "split ratios" in the unrelated companies' case, the operating profit of the "related companies" is then allocated (or split) with the same ratios. Obviously, in practice it is difficult to obtain the profit split ratio of comparable situations involving unrelated companies.

22.1(h)

Residual Profit Split Method

With the Residual Profit Split Method, a two-step process is employed. First, the operating profits are allocated for the "normal contributions" or functions of the related companies. Second, the remaining (residual) profit is allocated to the companies.

Example (Section 22 – Transfer Pricing Methods with Transfer of Properties - use of Residual Profit Split method)

XYZ is a corporation that develops, manufactures and markets a line of products for use by police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Forcegear). XYZ obtains patent protection for the chemical formula for Forcegear. Since its introduction, Forcegear has captured a substantial share of the market for bulletproof material.

XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Forcegear in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.

XYZ-Asia's research unit alters Forcegear to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2013 taxable year, XYZ-Asia manufactures and sells Forcegear in Asia through its marketing network under one of its brand names.

For the 2013 tax year XYZ has no direct expenses associated with the license of Forcegear to XYZ-Asia and incurs no expenses related to the marketing of Forcegear in Asia. For the 2013 tax year XYZ-Asia's Forcegear sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Forcegear business. The operating assets employed in XYZ-Asia's Forcegear business are $200 million. Given the facts and circumstances, the Country A taxing authority determines that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of Asian companies performing functions similar to those of XYZ-Asia the district director determines that an average market return on XYZ-Asia's operating assets in the Forcegear business is 10 percent, resulting in a market return of $20 million (10% X $200 million) for XYZ-Asia's Forcegear business, and a residual profit of $180 million.

Since the first stage of the residual profit split allocated profits to XYZ-Asia's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Forcegear, i.e. the Asian brand name for Forcegear and the Forcegear formula (including XYZ-Asia's modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2013 on Forcegear related research and development and marketing over the 2013 sales related to such expenditures.

As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The taxing authority determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the taxing authority capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in the 2013 tax year.

XYZ-Asia's expenditures on Forcegear research and development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development the taxing authority capitalizes and amortizes XYZ-Asia's expenditures and determines that they have a value in 2013 of $0.40 per dollar of XYZ-Asia's Forcegear sales;

Thus, XYZ and XYZ-Asia together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia's protective product sales for 2013, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm's length royalty for the Forcegear license for the 2013 taxable year is $60 million, i.e. one-third of XYZ-Asia's $180 million in residual Forcegear profit.

Section 23
Transfer Pricing Enforcement and Penalties

Under the TDA Regulations, any "**underpayment**" or "**understatement**" of tax due to transfer pricing adjustments will trigger Sections 73 and 74 of the UNTAET Regulation 2000/18.

Sections 73 of the UNTAET Regulations 2000/18 provides as follows:

Section 73
Failure to deliver tax payment

73.1 Subject to Sections 73.2 and 73.3, where a *person* who is required to deliver tax under the present Regulation fails to deliver all or part of such tax by the due date, that *person* shall be liable to additional tax of 5% of the tax not paid by the due date plus an additional 1% of the tax that remains unpaid on the 15th day of each month following the due date; and:

(a) if failure was due to gross carelessness on the part of the *person*, further additional tax of twenty-five percent (25%) of the tax that remains unpaid; or
(b) if failure was due to a deliberate attempt to avoid payment of tax, further additional tax of one hundred percent (100%) of the tax that remains unpaid.

73.2 Where the due date that any tax required to be delivered by under the present Regulation does not fall on a business day, the due date shall be the next business day following the due date.

73.3 In order for any tax that is required to be delivered under the present Regulation to the Central Payments Office or its nominated agent to be treated as having been delivered by the due date, the Central Payments Office or its nominated agent must have received that tax by that due date.

Section 74 of the UNTAET Regulations 2000/18 provides as follows

Section 74
Understatement of tax

Where a *person* who is required to complete a *tax form* under the present Regulation has understated the amount of tax required to be shown on that *tax form*, that *person* shall be liable to additional tax of fifteen percent (15%) of the understatement and:

(a) if the understatement was due to gross carelessness on the part of the *person*, further additional tax of twenty-five percent (25%) of the tax understated; or
(b) if the understatement was due to a deliberate attempt to avoid payment of tax, further additional tax of one hundred percent (100%) of the tax understated.

Note that under the UNTAET regulations Sections 73 and 74, there are separate penalties for (a) failure to pay tax and (b) the understating of the tax liability. Those tax infractions are separate and distinct from each other and the Timor-Leste tax administration applies each Section independently, where warranted.

While TDA Regulations Section 23 does not expressly indicate any standard, in order for the civil penalties under TDA Regulations Section 27 to apply, the internal policy of the Tax Administration that there needs to at least a ten (10) percent adjustment of the gross receipts of the taxpayer for the civil penalties to apply in the case of a transfer pricing adjustment.

Example (Section 23 – Transfer Pricing Enforcement and Penalties)

Company T was subject to a tax audit for the tax year 2013, with the audit examination on the transfer pricing arrangements of Company T with its affiliated associated enterprises. Company T's gross receipts as reported on its original tax return, before the audit, was US$10,000,000. The tax as reported and paid on the original tax return was US$300,000. The 2013 year tax return was filed, and the tax paid, on March 31 2014. After the audit, the Commissioner of Taxation issued a tax assessment against Company T, adjusting the gross receipts for the 2013 year to US$12,000,000.00, with an increase of $2,000,000 from the original reported gross receipts of $10,000,000. The additional tax due for 2013, as a result of the tax assessment, was US$600,000. The audit was concluded and the tax assessment was issued on Jan 31 2015.

The adjustment to Company T's gross receipts exceeded 10% of the original gross receipts amount (10% x $10,000,000 = US$1,000,000), as the adjustment was 20% of the gross receipts amount (US$2,000,000 / $10,000,000 = 20%), then the civil penalties Section 27 of the TDA Regulations will now apply. This inaccuracy of Company T's 2013 year tax return, because the net adjustment is 10 percent or more, is referred to as a "substantial valuation misstatement".

The civil penalties applicable are as follows:

Assuming that Company T paid the additional tax due based on the audit tax assessment issued on Jan 31 2015 on the same date (i.e. payment made on Jan 31 2015), then the UNTAET Section

73 penalty is: "additional tax of 5% of the tax not paid by the due date plus an additional 1% of the tax that remains unpaid on the 15th day of each month following the due date", calculated as follows:

5% x $600,000 = **$30,000**
1% x 10 months = 10% x $600,000 = **$60,000** (since after Mar 31 2014, the unpaid tax of $600,000 was not paid for 10 months on the 15th of each month beginning Apr 2014 to Jan 2015)

Since the Commissioner has determined that Company T's failure was due to gross carelessness, but not due to a deliberate attempt to avoid payment of tax, additional penalty of 25% x $600,000 = **$150,000**, will apply.

The total UNTAET Section 73 penalties is therefore: $240,000 ($30,000 + $60,000 + $150,000 = $240,000).

Then, under UNTAET Section 74, the following penalties will apply:
15% x $600,000 = **$90,000**, being 15% of the understatement of tax, as per Section 74.
25% x $600,000 = **$150,000**, being the understatement due to gross carelessness of the taxpayer, while the 100% penalty of Section 74(b) will not apply since the taxpayer was not determined to have deliberately attempted to avoid payment of tax.

Therefore, the total UNTAET Section 74 penalties are: $240,000 ($90,000 + $150,000 = $240,000).

As a result, the UNTAET Sections 73 and Section 74 penalties combined which will apply under the TDA Regulations, the resultant additional tax assessment due to the transfer pricing adjustments would be $480,000 (Section 73 penalty of $240,000 + Section 74 penalty of $240,000 = $480,000).

Section 24
Documentation Requirements

TDA Regulations Section 24 sets out the documentation requirements for transfer pricing purposes under Timor-Leste tax law.

Adequate transfer pricing documentation will make it easier for tax authorities to review a taxpayer's transfer pricing analysis and thereby contribute to avoiding a dispute or to a timely resolution of any transfer pricing disputes that may arise. Adequate documentation is characterized by (i) the sufficiency of the details demonstrating the taxpayers' compliance with the arm's length principle, as well as (ii) the timely manner in which such details are prepared and submitted to tax authorities upon their request. Therefore, it is in the interest of both the taxpayer(s) and the Tax Administration of Timor-Leste that the transfer pricing documentation in support of transfer pricing arrangements be well prepared, and that the rules for such documentation under the TDA Regulations be relevant and clear.

Under these guidelines for the TDA Regulations, first the documentation requirements of the TDA Regulations will be summarized, and then second, a discussion of the principles and objectives of transfer pricing documentation will be presented, in the context of Timor-Leste tax law.

The TDA Regulations documentation requirements are as follows:

- A taxpayer with an aggregate related party transaction or transactions in the sum of Five Hundred Thousand US Dollars (US$500,000) or more in a tax year is required to report and disclose such transaction(s) in the income tax return filed for the tax year
- Taxpayers are to keep and maintain accessible books and records containing all relevant information about such transaction(s) for a period of seven (7) years, commencing from the date the information or tax return containing the disclosures is filed
- Taxpayers are to compile transfer pricing documentation supporting the pricing of the related party transaction(s) in the sum of US$500,000 or more.

Under TDA Regulation Section 24(b), the transfer pricing documentation requirement is deemed met if the taxpayer maintains:

- sufficient documentation to establish that the taxpayer can reasonably conclude that, given the available data and the applicable pricing methods, the transfer pricing method as selected by the taxpayer in its transfer pricing methodology provided the most reliable measure of an arm's length result under the principles of the Best Method Rule as described the present TDA Regulations, and
- provides that documentation to the Tax Administration within sixty (60) days of a request for such documentation by the Tax Administration, in connection with an examination of the taxable year to which the documentation relates

- The documentation must be in existence when the return is filed. The Commissioner may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply and the taxpayer promptly remedies the failure when it becomes known.

Then, TDA Regulations provides that, for those taxpayer(s) which are required to prepare the transfer pricing documentation of the TDA Regulations, because they fall within the threshold as specified in the TDA Regulations, the documentation must be in existence when the return is filed. In other words, the documentation requirement is "contemporaneous" under the TDA Regulations. An exception for the contemporaneous requirement is made for items (viii) and (ix) of the **principal documents** listed below.

Under the TDA Regulations, for purposes of the contemporaneous documentation of the TDA transfer pricing rules, the **principal documents** to be maintained by the taxpayer include the following:

i. an overview of taxpayer's business, including an analysis of the economic and legal factors affecting pricing;

ii. a description of taxpayer's organizational structure covering all related parties engaged in transactions potentially relevant

iii. a description of the method selected and an explanation why the method was selected;

iv. a narrative of the alternative methods that were considered and the reasons for rejecting those alternatives methods;

v. a description of controlled transactions and any internal data used to analyze those transactions;

vi. a description of the comparables that were used, how comparability was evaluated, and what adjustments (if any) were made;

vii. an explanation of the economic/functional analysis and projections relied upon in developing the method;

viii. a description or summary of any relevant data that the taxpayer obtains after the end of the year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

ix. a general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

The TDA Regulations also provide that transfer pricing documentation prepared for a foreign tax jurisdiction will not be considered acceptable for Timor-Leste taxation purposes.

Transfer Pricing Documentation – Principles and Objectives – In the Context of Timor-Leste Tax Laws

The OECD's guidance on documentation is well summarized in the following paragraphs of the 2010 version of the OECD Transfer Pricing Guidelines[12]:

"Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations.

[12] 2010 OECD Transfer Pricing Guidelines, Section 5.28 and 5.29

Documentation requirements should not impose costs and burden on taxpayers that are disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.

Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of exchange of information articles in certain cases so that less need be asked of the taxpayer in the context of an examination …"

It is recognized that most non-OECD countries, such as Timor-Leste, do not have the extensive treaty networks of OECD countries and there will often have to be more reliance upon taxpayer provided information for this reason.

Under the OECD Guidelines, the following types of information among other things should be made available through documentation, although it is neither a minimum compliance list nor an exclusive list of information:

- Information about the associated enterprises involved in the controlled transactions and independent enterprises engaged in similar transactions;
- Information regarding the nature and terms of the controlled transactions, economic conditions and property involved in such transactions, product or service flows and changes in trading conditions or renegotiations of existing arrangements
- Description of the circumstances of any known transactions between the taxpayer and an unrelated party that are similar to the transaction with the foreign associated enterprise, and therefore might be an arm's length comparison;
- Outline of the business structure of the organization, including the associated enterprises and ownership linkages within the multinational enterprise group
- Information about the amount of sales and operating results of the associated enterprises from the last few years preceding the transaction; and

- Information on pricing, including business strategies and special circumstances that may be relevant, such as a "set-off" arrangement with the buyer providing the seller some services as part of the transaction.

Such information will help evaluate the functions performed by the associated enterprises, the assets used in doing this, and the risks assumed by the parties to the transaction, all of which will be important to a functional analysis, which has already mentioned in these guidelines to the TDA Regulations section, is a pre-condition to the proper selection of transfer pricing methodology.

In 2003, the Pacific Association of Tax Administrators ("PATA"), which is comprised of tax administrations from Australia, Canada, Japan and the U.S., announced its "Transfer Pricing Documentation Package" (the "Package"). At present, Timor-Leste is not a member of PATA, and accordingly, the PATA Package has no relevance to the documentation rules for purposes of the TDA Regulations.

In applying and interpreting the TDA Regulations as to what information to be included in the TP (transfer pricing) documentation, the following general principles should be borne in mind:

- In preparing TP documentation, taxpayers must decide the type and scope of documentation and information that should be provided to meet the documentation requirement and avoid any tax adjustments and penalties, while at the same time minimizing added burdens and potential tax exposure in the event of a tax audit

- The main objective of preparing and maintaining documentation is to place the taxpayer in a position where it can readily demonstrate that it has exerted reasonable efforts to ensure that its transfer prices are consistent with the arm's length principle.

- While the TDA Regulations expressly provides a list of the principal documents which should be maintained by the taxpayer, it should not be necessarily be considered as an exclusive listing, as it is not possible to specify a comprehensive list of documentation requirements that would meet the needs of all taxpayers and situations,

because the documentation required depends on the specific facts and circumstances of each case.

- First of all, information as to the related parties that are involved in the controlled transactions at issue needs to be documented. Such information includes i) an outline of business with transaction parties, ii) the structure of the organization, iii) ownership linkage within the multinational group, iv) the amount of sales and operation outcome from the last few years preceding the transaction; v) the level of the taxpayer's transactions with foreign related parties, for example the amount of inventory sales, value of services rendered, rent for tangible assets, the use and transfer of intangible property, and interest on loans, etc.. Information about functions performed, assets employed and risks assumed would be important items for TP documentation.

- The current business environment and forecasted changes or commercial and industry conditions affecting the taxpayer, such as market scale, competitive conditions, regulatory framework, technological progress, foreign exchange market, also may need to be documented.

- An explanation of the selection, application, and consistency with the arm's length principle of the transfer pricing method used for the establishment of the transfer pricing is also needed. Information on factors influencing the setting of prices or the establishment of any pricing policies for the taxpayer and the whole MNE group would be also useful.

- If the documentation is designed to allow the evaluation of comparables used in a transfer pricing study, it would not be sufficient merely to provide a list of "comparables." In cases where internal or third-party comparables are used by a taxpayer to support its transfer pricing policy, supporting documentation should be provided explaining the process followed to arrive at a particular list of comparables and the arm's length range of those comparables.

- Where a transfer pricing study relies on comparable information which has been obtained following such a process, it would be reasonable to expect each of the steps to be documented in order to make it possible for the tax administration conducting an audit to assess the quality of the analysis.

    - For example, if a taxpayer uses multiple-year data on the ground that its transactions are affected by business cycles, it would be reasonable for the taxpayer to provide some documentation explaining why a business

cycle is a factor to be considered, the type (e.g., business cycle, product cycle) and duration of the cycle and placement of the controlled enterprise in the cycle. Based on this analysis, the qualitative and quantitative criteria used to select or reject comparables should be carefully documented

- Where a taxpayer concludes that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amount at issue, reasons for such conclusion should be duly explained together with supporting documentation.

- Special circumstances would include details concerning any intentional set-off transactions that have an effect on determining the arm's length price. In such a case, documentation may be necessary to help describe the relevant facts, the qualitative connection between the transactions, and the quantification of the set-off arrangement. In this situation, contemporaneous documentation helps minimize the use of hindsight, and the possible suggestion of manipulation based on that hindsight.

- TP documentation for intra-group services is important to satisfy as to the legitimacy of intra-group service charges, including management fees. When TP documentation is prepared for intra-group services, it should be focused on whether intra- group services have in fact been provided and what the intra-group charge should be for such services for tax purposes. Once the relevant intra-group services have been identified, the documentation of such intra-group services performed by the service provider and the benefits received by the service recipient should be thoroughly prepared.

- A cost contribution arrangement (CCA)[13] is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. Documentation is crucial for the proper operation and tax treatment of a CCA because the form and value of each participant's contribution cannot be properly obtained without proper documentation. Prudent business management principles would lead the participants to a CCA to prepare or obtain materials regarding the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle.

    - Over the duration of the CCA's term, the following information could be particularly useful:

[13] In some tax jurisdictions, this is referred to as "cost sharing arrangement"

- Terms, participants, subject activity and conditions of initial arrangements and any change to the arrangement;
- The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
- The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined;
- Any provisions for balancing payments or for adjusting the terms of the arrangements to reflect changes in economic circumstances;
- A comparison between projections used to determine expected benefits from CCA activity with the actual results; and
- The annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's terms, and a detailed description of how the value of contributions is determined and how accounting principles are applied consistently to all participants.

Section 25
Value of Petroleum

TDA Regulations Section 25 prescribes the valuation methodology for petroleum, for Timor-Leste taxation purposes.

Petroleum Valuation

Under TDA Reg. Sec. 25.1, petroleum is to be valued Free On Board (FOB) at the point at which petroleum from a Contract Area leaves the Contract Area, or at such earlier point at which it is loaded onto or enters a vessel, pipeline, or other means of transportation to be transported from the Contract Area.

Crude Oil Valuation

Under TDA Reg. Sec. 25.2, the value of Crude Oil sold and or exchanged is:

(a) Free On Board (FOB) or equivalent circumstances at the Field Export Point in transaction between parties that are at arm's length is the price agreed between the parties and payable by the buyer; or

(b) other than FOB or equivalent circumstances at the Field Export Point in transaction between parties that are at arm 's length is the price payable by the buyer, less such fair and reasonable proportion of such price that relates to the transportation and delivery of the petroleum downstream of the Field Export Point; and

(c) other than as described in (a) and (b) above, is the price that would have been payable having regard to all relevant circumstances and similar arm's length transactions.

Under Reg. Sec. 25, it is the Contractor who has the burden of establishing that the pricing in subparagraphs 25(a) to (c) is at arm 's length and consistent with the transfer pricing rules of the TDA Regulations.

Natural Gas Valuation

Under TDA Reg. Sec. 25.3, natural gas is valued at the price payable:

(a) under the contract approved by the Designated Authority; or

(b) as may be otherwise be provided in the Development Plan; or

(c) as may be otherwise provided in a Petroleum Contract.

Under TDA Reg. Sec. 25, the price payable for petroleum or Natural Gas shall be the respective fair market value, or the price that would be payable by the buyer if the petroleum or the Natural Gas were delivered by the Contractor and taken by the buyer, without conditions such as set off, counterclaim, novation, claim of right or other withholding of any description, nature or form.

Example (Section 25 – Value of Petroleum)

Polar Corp. is a Contractor extracting crude oil in a Contract Area. It has entered into a sales agreement with a buyer (S Corp.) of the extracted crude oil. S Corp. is an unrelated party. The sales agreement's terms is that Polar will sell the crude oil on an FOB basis. In this situation, the FOB price as indicated in the agreement between Polar corp. and S Corp. can be used as the valuation of the crude oil, for Timor-Leste purposes, as per TDA Regulations Section 25.

Section 26

Withholding Tax

A withholding tax, is a requirement of the Timor Leste government for the payer of an item of income to withhold or deduct tax from the payment, and pay that tax to the Tax Administration of the Timor Leste government.

In Timor-Leste, as in many other jurisdictions, withholding tax applies to specified categories of income. Many jurisdictions also require withholding tax on payments of interest or dividends. Governments use withholding tax as a means to combat tax evasion, and sometimes impose additional withholding tax requirements if the recipient has been delinquent in filing tax returns or in industries where tax evasion is perceived to be common.

In certain cases, the withholding tax is treated as a payment on account of the recipient's final tax liability. It may be refunded if it is determined, when a tax return is filed, that the recipient's tax liability to the government which received the withholding tax is less than the tax withheld, or additional tax may be due if it is determined that the recipient's tax liability is more than the withholding tax. In some cases the withholding tax is treated as discharging the recipient's tax liability, and no tax return or additional tax is required.

The substantive TDA Regulations on withholding tax requirements are as follows:

> **26.1** Any payment made by a Contractor or Subcontractor in respect of any Timor-Leste services income to a person, other than a payment made to an employee in circumstances where there is an employer-employee relationship, in respect of services for Petroleum Operations, is subject to a withholding tax at six percent (6%) of the gross amount paid.
>
> **26.3** Payments made for tangential services and which are not connected with the core business of a Contractor or Subcontractor engaged in Petroleum Operations is NOT subject to the withholding tax regime of Section 81 of TDA

26.5 This section expressly lists the services subject to withholding under TDA Section 81 as follows:

a) Accounting/bookkeeping, Tax and legal services;
b) Logging services;
c) Pest extermination and cleaning;
d) Drilling services and supporting of mining oil and natural gas, except what is carried out by permanent establishments;
e) Supporting services in the field of oil and gas;
f) Sound dubbing services and/or film mixing;
g) Catering services;
h) Cleaning services;
i) Brokerage services;
j) Appraisal services;
k) Actuarial services;
I) Supplies;
m) Medical services;
n) Repairs and or Maintenance;
o) Engineering;
p) Consultancy;
q) Lease and Rental services;
r) Labour / Personnel supply;
s) Security;
t) Construction services (except turnkey);
u) Transportation (air, land or sea); and
v) Courier services.

Then, TDA Regulations Section 26.6 lists the following as "supporting services" in the field of oil and gas (including but not limited to):

a. primary cementing service, which is the placement of liquid cement between the cover pipes and opening of the well;
b. remedial cementing services, which is the placement of liquid cement for the following purposes;
c. the re-plugging of empty formation and zone producing water;
d. rectification of a failed or damaged primary cementing;
e. the sealing\closing off of a well;
f. sand control services, which are services which guarantee that parts of the formation which are not consolidated shall not be included in the production of the series of production pipes and eliminate the possibility of getting the pipe blocked;
g. matrix aciding services, which are activities to increase the productivity by way of eliminating the unwanted blockage material;
h. hydraulic fracturing services, which is the work performed in the event the matrix acidizing is not successful, e.g. the maintenance at the formation which has a very mall perforating power;
I. nitrogen and coil tubing services, which are services rendered to eliminate the artificial liquid which is in the completed well, thereby causing the flow which occurred pursuant to the original pressure of the formation and thereafter becomes enlarged as a result of the nitrogen gas which has been pumped into the artificial liquid in the well;
j. drill stem testing services, temporary completion of a new well, in order to evaluate the production capacity;
k. pump services;
I. installation and maintenance services;
m. replacement services of equipment/material;
n. mud logging services;
o. stimulation and secondary recovery services;
p. well logging services and perforating services;
q. stimulation and secondary recovery services;
r. well testing and wire line services;
s. services in regard to off-shore navigational equipment which is related to drilling;
t. maintenance services for the drilling activities;
u. mobilization services and demobilization of drilling extension;
v. other similar services in the field of drilling oil and gas.

Section 27
Finality of Withholding Tax

TDA Regulation Section 27 defines the conditions under which a withholding tax is considered the final discharge of the taxpayer(s)' tax payment obligation.

TDA Reg. Sec. 27(a) states that to the extent that payment received has been properly subject to withholding tax, then such a recipient (i.e. payee) can consider the withholding tax obligation as having been discharged.

TDA Reg. Sec. 27(b) provides that if the beneficiary earned any separate income (e.g. from the sale of goods or interest income, whether combined with services or not) other than arising in connection with the performance of services and which has been correctly subject to the withholding tax, such a person will be required to file an income tax return and make the tax payment (if any) accordingly. The beneficiary will be entitled to exclude the portion of the income already subject to withholding tax from other income reported in the tax return.

Then, TDA Reg. 27(c) simply reiterates that the withholding tax is imposed on the gross amount of income, without the allowance of any deductions against the income when computing the withholding tax.

Section 28, 28A, 28B, 28C
Withholding Tax on Wages Income
Other Income subject to Withholding Tax
Other Withholding Taxes

Sections 28, 28A, 28B and 28C of the TDA Regulations further provide the substantive detailed rules of withholding taxes on various types of income, pursuant to the TDA Sections 53, 54 and 72

Withholding Tax on Wages Income

TDA Reg. Sec. 28 addresses the withholding tax on Wages income, and refers to TDA Section 72.2 and TDA Schedule IX.

TDA Schedule IX provides the following:

Status of Employee	**Wage amount monthly (US$)**	**Withholding Tax rate**
Resident Natural Person Employee With ID #	$0 - $550	10%
Resident Natural Person Employee With ID #	Over $550	$55 + 30% of amt over $550
Non-Resident Natural Person	All wage amounts ranges	20%
All other cases	All wage amounts ranges	30%

- If an employee receives taxable wages for a period of less than one month, the rates of wage income tax set out in paragraph (a) are imposed on a pro-rata basis.

Other Income Subject to Withholding Tax

TDA Reg. Sec. 28A addresses the withholding tax on the following types of income. (**However, note additional rules on withholding tax on Dividend payments in TDA Reg. Sec. 28B below.**)

Type of Income	**Recipient**	**Comments / Notes**	**Withholding Tax rate**
Dividends	Timor-Leste Resident Company or Person		15%
Dividends	Timor-Leste "PE" of Non-Resident Australian Person		15%
Interest (inclu. Premiums, discounts, loan guarantee fees)	Timor-Leste Resident person		15%
Interest (on loan guaranteed)	Timor-Leste "PE" of a Non-resident person who is Australian resident		10% (and 13.5% in all other cases)
Royalty	Other than Timor-Leste Non-resident person, who is Australian resident		15%
Royalty	Timor-Leste Non-resident person, who is Australian resident		10% (and 13.5% in all other cases)

Withholding Tax on Dividends

TDA Reg. Sec. 28B provides the following withholding tax rates on dividend payments, (**other than those circumstances specified in Reg. Sec. 28A above**), as follows:

Type of Income	Recipient	Comments / Notes	Withholding Tax rate
Dividends	Timor-Leste "PE" of Non-Resident Person (who is NOT Australian resident)		13.5%
Dividends	Timor-Leste "PE" of company which is NOT Australian resident		13.5%
Dividends	Timor-Leste "PE" of Non-Resident person		13.5%

TDA Reg. Sec. 28C provides the following withholding tax rates:

Type of Income	**Recipient**	**Withholding Tax rate**	**Withholding Tax rate In JPDA (except Annex F)**	**Withholding Tax rate In TL Exclusive area**
Gifts and rewards paid by employers	Employee	13.5%		
Payments in connection with drilling or drilling support			5.4%	6.0%
Rental payments for lease of land or building, paid by Contractor	Natural person		9.0%	10.0%
Rental or lease payments for use of properties			5.4%	6.0%
Drilling services and drilling support services payments	Any recipient (except for services performed by a "PE")		5.4%	6.0%
Rental payments for lease of land or building	Legal person or natural person		9.0%	10.0%
Shipping services commencing and ending in Timor-Leste			5.4%	6.0%
Air transportation services commencing and ending in Timor-Leste or anywhere			5.4%	6.0%
Construction services or Construction consulting services			5.4%	6.0%
Following services: Technical, management, accounting, bookkeeping, legal, tax consulting, brokerage, appraisal, actuary, film dubbing mixing, manpower supply, pest control, cleaning, logging / timber cutting			5.4%	6.0%
Architectural services, interior design, landscape design			5.4%	6.0%
All other types of services not specifically mentioned above			5.4%	6.0%

Section 29
Obligations of a Person Withholding Tax from a Payment

In the Law on Income Tax and also TDA, there are various legal requirements for Timor-Leste taxes to be withheld by the payor on gross income amount(s) owed to the recipient(s). These are referred to as "withholding tax" obligations.

To properly discharge the withholding tax obligations under these tax regulations, the payor (that is, including a Contractor or sub-Contractor) have to perform the following:

- Remit the tax withheld within fifteen (15) days after the month end (of the month that the payment was made by the payor to the payment recipient)

- The withheld tax is to be paid over to Timor-Leste Central Bank, through its Petroleum Fund Account

- Issue a "withholding tax notice" to the payment recipient, stating the following information: (i) amount of the gross income amount owed to the recipient, (ii) tax withheld from such gross income amount.

To encourage prompt payment of withheld Timor-Leste taxes, the government of Timor-Leste has adopted the "trust fund tax" concept, similar to that in many other countries, regarding the withheld taxes. These taxes are called trust fund taxes because the payor are considered to hold the money (the tax imposed on the gross amount of income owed and paid to the payment recipient) in trust on behalf of the recipient and the Timor-Leste government until the payor make a tax deposit in that amount with the Timor-Leste Central Bank. That is why, under the Regulations, a Contractor or Subcontractor who fails to withhold tax in accordance with law is personally liable to pay the amount of the tax which has not been withheld. Accordingly, the payor (that is, the Contractor or Subcontractor, who is obligated to withhold tax) is treated as an "agent" of the Timor-Leste Tax Administration, to the extent of the taxes required to be withheld. The Tax Administration takes the position that if a payment was made by a payor to a

recipient and the taxes were not withheld as required, then both the payor and recipient are held jointly and severally liable for such unpaid taxes.

Persons Responsible for the Liability of Taxes which were required to be withheld, but which were in fact not withheld:

The liability of taxes required to be withheld, but were in fact not withheld by the payor, can be charged personally against any person who:

- Is responsible for collecting or paying withheld income and taxes, or for paying collected taxes, and
- Negligently or willfully fails to collect or pay them.

A responsible person is a person or group of people who has the duty to perform and the power to direct the collecting, accounting, and paying of the taxes. This person may be:
•An officer or an employee of a corporation,
•A member or employee of a partnership,
•A corporate director or shareholder,
•A member of a board of trustees of an organization,
•Another person with authority and control over funds to direct their disbursement,
•Another corporation or third party payer,
•Payment service providers (PSP), such as a payroll service company or a bookkeeping company or responsible parties within a PSP
•Responsible parties within the common law employer (client of PSP/PEO).

For the liability to be imposed, it is sufficient that the responsible person:
•should have been aware of the outstanding taxes and
•Either intentionally disregarded the law or was indifferent to its requirements.

For example, using available funds to pay other creditors when the business is unable to pay the withheld taxes is an indication of willfulness.

Example (Section 29 - Obligations of a Person Withholding Tax From a Payment)

Company J is a Subcontractor operating in the Bayu-Undan oilfield, through a permanent establishment there. For the month of June 2013, Company J had a payroll compensation of $80,000 with employees who are classified as dependent non-resident employees, for services they provided. Under the applicable regulations, Company J is required to withhold 18% tax (being 20% of 90% of the gross amount) on the $80,000 of payroll compensation, or $14,400. Company J did in fact withhold $14,400 of taxes from their employees for June 2013, and paid the employees $65,600 of net amount, after deducting the $14,400 of taxes imposed.

However, instead of remitting the $14,400 of withheld taxes to the Timor-Leste Central Bank, Company J used the $14,400 to pay a company to purchase a jeep for the company's general manager, Mr. R Smith. It was the general manager who authorized this payment and was the one who signed the check to pay for the jeep.

Under the Regulations, both Company J and R. Smith, the general manager are held responsible for the liability of the $14,400 of withheld taxes. R. Smith, being a responsible person, is personally liable for the $14,400 to the Government of Timor-Leste.

Section 30
Annual Income Tax Return

30.1

Due Date of Annual Income Tax Return

Since for most taxpayers the tax year is a calendar year from 1st January to 31st December, the due date of the annual income tax return will be on 31st March of the year following the end of the tax year on 31st December.

Example 1

Company A uses the calendar year as its tax year. For the tax year ended 31st December 2013, the annual income tax return of Company A will be due on 31st March 2014.

When the due date prescribed under the Regulations for filing a tax return (or for performing any act under the Regulations) falls on a Saturday, Sunday, or legal holiday, then the due date or the act shall be considered performed timely if performed on the next succeeding day which is not a Saturday, Sunday, or legal holiday. For this purpose, any authorized extension of time shall be included in determining the last day for performance of any act.

Legal holidays. For the purpose of these Regulations, the term legal holiday includes the legal holidays as published by the Prime Minister of Timor Leste.

In order to be considered as timely filed, the tax return must be actually received by the Tax Administration on or before the due date of the tax return. While the taxpayer may use mail, express delivery courier services or private delivery services, the taxpayer assumes the risk of using such delivery methods, and the taxpayer must ensure that the tax return is actually received in a timely manner by the Tax Administration in order for the tax return to be considered as : (a) filed and (b) delivered in a timely manner.

Place of filing of annual income tax return

Unless otherwise notified by the Ministry of Finance, annual income tax returns of taxpayers subject to the TDA regulations are to be delivered to the Tax Administration at the following address:

National Directorate of Petroleum and Mineral Revenue
Ministry of Finance
Palacio do Governo
Building No. 5
Av. Presidente Nicolau Lobato
P.O. Box 18
Dili, Timor Leste

Example 2
Company Y submitted its 2013 year tax return. Despite having significant (exceeding the $500,00 threshold) related party transactions during 2013, the required transfer pricing documentation relating to its related party transactions were not exhibited to its tax return as filed with the Tax Administration of Timor Leste. Company Y is deemed not to have filed a complete tax return for the 2013 year, and can be subject to administrative penalties under the Regulations.

30.3

Extension of Time to File Tax Return

In applying for an extension of time to file the annual income tax return under Section 15, the taxpayer (Contractor or Subcontractor) must make the request in writing, with such request delivered to the Tax Administration on or before the date of the regular due date for filing such tax return.

While the TDA Regulations Section 30 does not expressly set out the format and contents of a taxpayer's request for extension of time to file a tax return, the following are internal policies of the Timor-Leste Tax Administration, and the taxpayer(s) should consider the following as suggested guidelines as to the form and content of an application for extension:

The application for extension of time to file tax return must be submitted in writing, and is to contain the following:

1. Name and address of the taxpayer;
2. Tax identification number of the taxpayer;
3. Year for which the last tax return was filed by the taxpayer;
4. Year for which the extension is being requested for;
5. (a) Total estimated tax for the tax year, (b) estimated taxes paid to date, (c) amount of tax payment accompanying the extension application, (d) proof of the payment of 100% of the estimated tax for the year;
6. Reason for the extension request; and
7. Signature of taxpayer's representative and date.

Upon receipt of the extension request, the Tax Administration will review such request and inform the taxpayer as to whether such request has been approved or denied.

Upon receipt of notification from the Tax Administration of an approval for the extension, the taxpayer is to file the income tax return by the new extended due date.

If the Tax Administration has denied the request, the taxpayer must file the tax return within ten (10) days of the date of notification.

Example 3

Company B, in determining that it is unable to complete and file its 2013 tax return by the regular due date of 3^{1st} March 2014, submitted on 15th March 2014, a request to the Commissioner of Taxation for an extension of time to file its tax return for a period of three months. In its application, the Company B enclosed a proof of payment of US$18,000 as the balance of estimated tax payment in respect of its 2013 estimated tax liability. On 25th March 2014, the Commissioner of Taxation notified Company B that the an extension has been granted for a period of two months to file its 2013 tax return. Company B must file a complete and accurate income tax return to the Tax Administration by 31st May 2014.

Example 4

In the example above, Company B, having submitted its request on 15th March 2014 for an extension of time to file its 2013 tax return, failed to enclose proof of payment of $18,000 of the balance of its 2013 estimated tax. Accordingly, on 31st March 2014, Company B still owes $18,000 of tax and has only paid 75% of its estimated tax liability for 2013. On 25th March 2014, the Commissioner of Taxation notified Company B that its request for extension of time to file tax return has been denied. Company B must submit its 2013 tax return and any outstanding tax payment to the Tax Administration by 5th April 2014. Company B will be subject to a late payment penalty for failure to pay 100% of its 2013 year tax when due on 31st March 2014, up until its tax was actually paid on 5th April 2014.

Section 31
Contractor's Monthly Income Tax Obligations

TDA Regulations Section 31 provides the detailed rules on a Contractor's monthly estimated income tax payment compliance requirements.

The requirements can be summarized as follows:

With respect to a Contractor's first year, the Contractor shall provide an estimate of the projected tax liability to the Tax Administration not later than the 15th day of the month following the first period of thirty (30) consecutive days during which the average level of regular production delivered for sale on the twenty five (25) highest days in the thirty-day period reaches a level of regular production delivered for sale as determined by the Tax Administration.

First Year Monthly Income Tax Obligations

- After level of regular production is reached in 30 day period (based on 25 highest production days average is achieved in a 30 day period), Contractor to provide tax estimate to Tax Administration by 15th day of next month

- Estimated (projected) tax liability divided by 12 months. Contractor is to pay 1/12th of estimated tax, on monthly basis, on 15th day of next month, for the estimated tax of the preceding month

Post First Year monthly Income Tax Obligations

- After first year, Contractor's monthly estimated tax is to be based on prior year's income tax liability, subject to the **exception** mentioned below
- The monthly estimated tax payment is to be one twelfth (1/12th) of the following two amounts, a. or b., whichever is higher:
    a. Estimated tax installment payment amount for last month of preceding year, or
    b. Average monthly tax installment payment for preceding year

EXCEPTION to using prior year tax liability as basis for estimated tax:

- Contractor may apply and obtain Commissioner's approval to base current year estimated tax payments without using prior year's tax liability as the basis for estimate, if Contractor believes that using prior year's tax liability will result in material underpayment of tax for current tax year
- Upon approval by the Commissioner, the Contractor can then start using the revised estimated tax liability amount as the basis to compute the $1/12^{th}$ amount to be paid on a monthly basis. Any underpayment of tax preceding the revised / substituted tax liability is to be paid within five (5) days upon notification of approval by Commissioner

Special Circumstances where Estimated Tax is Determined by Commissioner

The Commissioner may determine the estimated tax of a Contractor under the following circumstances:

(a) a Contractor has a loss carried forward for the preceding tax year;
(b) a Contractor derives irregular income;
(c) the income tax return of a Contractor for the preceding tax year is delivered after the due date, inclusive of any extension of time granted
(d) there is a material change in the Contractor's circumstances, including merger or acquisition or a natural disaster;
(e) a Contractor's income tax return for the preceding year is amended, either as a result of a tax audit or self-amendment; and
(f) a Contractor fails to provide the Tax Administration with estimated income tax liability as required under the TDA Regulations

Revision of Previously Submitted Estimated Tax Payment

A Contractor can revise the estimated tax liability payment previously submitted, provided that the Tax Administration's consent has been applied for and obtained in advance.

- Underpayment resulting from revision of estimated tax liability
  If an underpayment arises from the revision of a Contractor's previous estimated tax liability, the underpayment has to be paid by the next installment payment date after

receiving the approval of the revision by the Tax Administration

- Overpayment resulting from revision of estimated tax liability
  If an overpayment results due to a revision of a Contractor's estimated tax liability, the overpayment may be applied as a credit against future monthly tax liability of the Contractor

Penalty for Underpayment of First Year Estimated Tax Liability

If the Contractor's estimated tax payment for the first year, as declared and submitted by the Contractor, is less than ninety (90) percent of the Contractor's actual tax liability for such tax year, then the following penalty can be imposed:

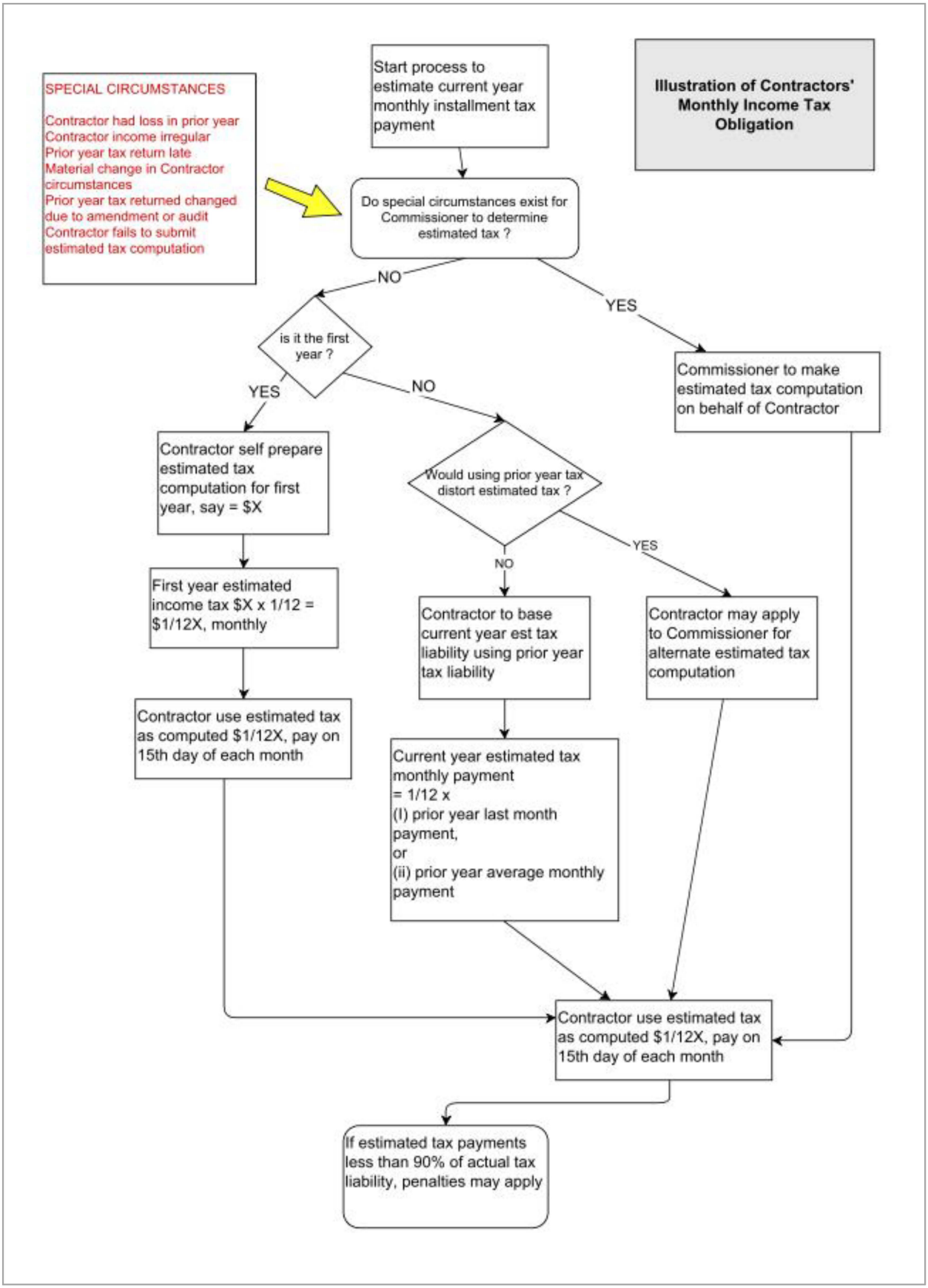
- if the underpayment of estimated tax is due to fraud or willful neglect, the penalty is fifty (50) percent of the difference between the estimated tax liability and the actual tax liability (referred to as "tax shortfall"

- In other cases (i.e. the underpayment of estimated tax is NOT due to fraud or willful neglect , the penalty is ten percent (10%) of the tax shortfall

- **EXCEPTION** to penalty for Underpayment of First Year Estimated Tax Liability:
  However, if the reason for the shortfall is
  - due to circumstances beyond the Contractor's control, such as natural disaster, material and or significant price fluctuations, and
  - that the Contractor exercised all diligent and reasonable care in making the estimate

  then the Commissioner may waive the tax penalties.
  The taxpayer bears the burden of showing the exceptional circumstances listed above.

  A diagram of the Contractor's Monthly Income Tax Obligation is shown on the next page.


Illustration of Contractors' Monthly Income Tax Obligation
Start process to estimate current year monthly installment tax payment
SPECIAL CIRCUMSTANCES
Contractor had loss in prior year
Contractor income irregular
Prior year tax return late
Material change in Contractor circumstances
Prior year tax returned changed due to amendment or audit
Contractor fails to submit estimated tax computation
Do special circumstances exist for Commissioner to determine estimated tax ?
NO
YES
is it the first year ?
YES
NO
Commissioner to make estimated tax computation on behalf of Contractor
Contractor self prepare estimated tax computation for first year, say = $X
Would using prior year tax distort estimated tax ?
YES
NO
First year estimated income tax $X x 1/12 = $1/12X, monthly
Contractor to base current year est tax liability using prior year tax liability
Contractor may apply to Commissioner for alternate estimated tax computation
Contractor use estimated tax as computed $1/12X, pay on 15th day of each month
Current year estimated tax monthly payment
= 1/12 x
(I) prior year last month payment,
or
(ii) prior year average monthly payment
Contractor use estimated tax as computed $1/12X, pay on 15th day of each month
If estimated tax payments less than 90% of actual tax liability, penalties may apply

The Supplementary Petroleum Tax Regime

The Supplementary Petroleum Tax (SPT) regime is governed primarily by Sections 84-87 of the TDA and 32-38 of the TDA Regulations. The SPT is separate and distinct from the Corporate Income Tax (CIT) and it additional tax imposed only on Contractors after reaching certain milestones (i.e. recovery of cost). The SPT is payable only where a Contractor has a positive amount of accumulated net receipts arising from Petroleum Operations for a tax year. The SPT payable for a particular year is deductible in the calculation of the taxable income of the Contractor in the year in which the Contractor is subject to SPT.

The SPT is calculated in accordance with this formula:

A x 22.5% / (1-r)
where:
A: is the "accumulated net receipts" of the Contractor for the Petroleum Operations for the year; and
r: is the rate of corporate Income Tax (30% as stipulated in Section 72.1 of the TDA).

The accumulated net receipts (ANR) of a Contractor for Petroleum Operations as prescribed under Section 84.1 of the TDA for a tax year is calculated according to the following formula:

((A x 116.5%) – (I x (1-r))) + B

where:

A: is the Contractor's accumulated net receipts for the Petroleum Operations at the end of the previous tax year (entered as a negative to denote a loss), and is deemed to be nil if SPT was payable in the previous year of tax;

B: is the Contractor's "net receipts" from Petroleum Operations for the current tax year;
"Net receipts" of a Contractor for a tax year is the "gross receipts" of the Contractor for the year, less the total deductible expenditure of the Contractor for the Petroleum Operations for that year (this may be negative).

The definition of "gross receipts"[14] is very expansive and it includes but not limited to income accrued for Income Tax purposes and other amounts received by the Contractor but interest income and amounts received or accrued as consideration for the transfer of an interest in Petroleum Operations are excludible.

l: is the interest expense and other financial charges paid by the Contractor in respect of the

[14] Sections 34 of the Regulation DTA-IX/12, 86 of the TDA.

Petroleum Operations in the current tax year and is entered in the formula as a negative number; and
r: is the rate of corporate Income Tax (30% currently).

The position of the Timor-Leste Tax Administration is that in the ANR equation above, if the component (A x 116.5%) is negative for a tax year, that component cannot be offset by (I x (1-r)), such that the result of ((A x 116.5%) - (I x (1-r))), is lesser than A, in absolute terms.

Example- SPT Calculation

Assume the followings for a Contractor named Holly Energy Corporation (HEC) for the tax year ended December 31, 2011:

Gross Receipt (excluding interest income)	US$400,000,000
2011 deductible expenditure (including interest & financial charges	(5,000,000)
Capital expenditure incurred in 2011:	(30,000,000)
Operating expenses in connection with Petroleum Operations	(40,000,000)
CIT @30% on taxable income before deducting SPT	(75,000,000)
Total deductible expenditure for 2011	**$150,000,000**
Net Receipts of the 2011 year ($400m-150m)	250,000,000
Accrued Net Receipts (ANR) as on Dec. 31, 2011	**250,000,000**
ANR after JPDA reduction (ANR X 90%)	**225,000,000**
SPT Payable (ANR after JPDA reduction x22.5/70%)	**72,321.428**
SPT installments paid during 2011	(70,000,000)
SPT due ($72,321,428-70,000)	**$2,321,428**

SPT-Payment and Reporting Obligations & Procedure

To the extent that a Contractor is subject to SPT, the reporting obligations and procedure is substantially the same as those of Corporate Income Tax. The due date[15] for the SPT payment and the informational/tax return is the same as the annual income tax (i.e. 31 March of the year following the affected tax year).

Consistent with the income tax reporting obligations and procedure, Contractors that are subject to SPT are mandated to prepare estimated tax liability for the year and make installment payments calculated at 1/12th of the estimated annual SPT liability, and remit 1/12th on a monthly basis. Just like the monthly installment obligations, the SPT monthly tax installment is due on

[15] Sections 83 of the TDA, 38 of Regulation TDA-IX/12

the 15th of each successive month.[16]

SPT- Nature of deductible expenditures

It should be noted that the items, nature and categories of permissible deductions for the purposes of calculating the taxable corporate income tax are not the same as those permissible for calculating SPT. The items that are permissible for calculating the SPT are:

1. expenditures incurred during the current year by a Contractor in connection with Petroleum Operations but excluding items of *depreciation*, *amortization*, *interest* and other *financing charges*;
2. capital expenditure incurred during the current year for the acquisition or construction of a tangible or intangible asset used in the Petroleum Operations of a Contractor in a particular contract area, excluding any amount paid as *consideration for the acquisition of an interest* in a Petroleum Operations;
3. exploration expenditure incurred by the Contractor during the current year in a particular contract area; and
4. the corporate income tax paid by the Contractor-excluding any penalties and or interest imposed under Sections 72-74 of the UNTAET Regulation 2000/18.

Tax Audit

Section 41 of the TDA Regulations provides that the Tax Commissioner shall have the authority to conduct periodic tax audits to test tax compliance. The following sections also deal with the tax audit process:

Section 42 (Tax Audit Methods)

Section 43 (Office Control)

Section 44 (Processing of Tax Returns and Other Statements of the Taxpayer)

Section 45 (Participation of a Taxpayer in Office Control Procedure)

Section 46 (Change of Tax Liability upon Findings of Desk / Office Controls)

Section 47 (Field Audit Controls)

Section 48 (Location of Field control)

Section 49 (Time of Field Control)

[16] Sections 83, 89 and 90 of the TDA, 38 and 39 of Regulation TDA-IX/12.

Section 50 (Report)

The outcome of an effective audit process is two-fold:

(i) encourage future compliance and

(ii) increased current tax revenues (where cases are successfully audited).

The better the "quality" of the cases referred to audit, the higher the probability of successful audits and vice versa. It is therefore just as important to dedicate adequate time and resources to risk assessment as it is to dedicate the appropriate time and resources to the audit of a case.

Risk assessment is carried out at various stages of the audit after the initial risk assessment leading to the determination to commence a tax audit. The periodic risk assessment is similar to a cost/benefit analysis, to ensure the most efficient and effective use of time and resources. This model is built into the auditing process and incorporated as part of each audit plan. A risk identification and assessment process followed by engagement with the taxpayer can at times be a worthwhile approach to adopt. This allows for better understanding of the risks identified and gives taxpayers the opportunity to explain the commercial context of the transactions/risks identified. Such an approach is again designed to ensure that the risks have been profiled in the most robust manner before resources are committed to carrying out an in-depth audit.

It is also useful to organize an audit manual, which will provide the policies and standardized procedures in conducting audits. Then, for each taxpayer selected for audit, an audit program should be developed for the specific audit. The audit program should include as many details as possible, such as: type and quantity of information to be requested, location(s) of audit, personnel of the taxpayer to be present at various stages of the audit, areas of audit focus, expected timing of the audit.

In making selections of audit targets, attention should be paid as to those which may have a higher risk of **transfer pricing audit issues**:

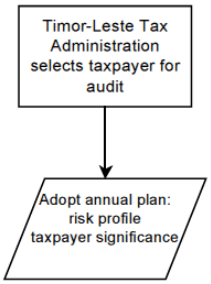
- Consistent and continued losses;
- Transactions with related parties in countries with lower effective/marginal tax rates, especially secrecy jurisdictions;
- Local low profit or loss making companies with material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralised supply chain companies in favourable tax jurisdictions i.e. centralised sourcing or marketing companies located in jurisdictions with low or no tax regimes and which are not located in the same country/region as the group's main customers and/or suppliers.
- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing rules – the corporate group may be more likely to set transfer prices in favour of the more aggressive jurisdiction at the cost of the less aggressive jurisdiction, due to the higher likelihood of intense scrutiny in the first jurisdiction.
- The same applies in the case of material commercial relationships with companies located in the "home" jurisdiction of the MNE or the location where the holding company is listed.

- Similar considerations apply where there are material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align to the arm's length principle.

Accordingly, in the selection of taxpayer audit targets, the following factors are considered by the Timor-Leste Tax Administration, in accordance with the TBUCA Regulations[17]:

- Develop and adopt annual plan
- Tax risk profile of taxpayer
- Significance of the taxpayer
- Evaluate effect of tax audit and control on efficiency of tax collection

[17] Section 41(c), Regulation TDA-IX/12.



Authority of Timor-Leste Tax Administration to access Taxpayer Information

While TDA Regulations Section 41 does not expressly state what powers a Timor-Leste officer or employee of the Tax Administration (as designated and acting via the authority of the Commissioner) may have in the context of a tax audit, the are various enabling Timor-Leste laws forming the statutory basis for a tax audit in the areas subject to Regulation TDA-IX/12 and the TDA. The UNTAET Regulation 2000/18[18], TDA and the Ministerial Diploma 3/2009[19], issued pursuant to Decree-Law 13/2009 cumulatively provide the legal framework for a tax audit of the taxpayers subject to the TDA.

Pursuant to the applicable laws, the Timor-Leste Tax Administration :

- may examine the relevant books, papers, records or other data
- take relevant testimony of the person concerned, under oath
- summon the person liable for tax or required to perform the act, or any officer or employee of such person or any person having possession, custody, or care of books of accounts containing entries relating to the business of taxpayer to appear before one or more officers or employees of the Tax Administration to produce such books, papers, records, or other data to give relevant testimony, under oath
- take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry

[18] See- UNTAET Reg. 2000/18, Sections 51, 62-64.
[19] See-Articles 17(a), (b), (d), (e), 18(1), 2(e),(f), (g), (h) and (j).

- collect transfer pricing information and associated documents from taxpayers and examine pertinent transactions to establish whether transfer pricing issues exist under the petroleum law and regulations
- prepare audit plan, conduct both field and desk audits

This summons power may be used in an investigation of either civil or criminal tax related liability.

It is the policy of the Timor-Leste Tax Administration that, in the course of a tax audit, the Commissioner may designate one or more officer or employees and authorize such individuals to take testimony under oath of the person summoned and to receive and examine books, papers, records, or other data produced in compliance with the summons.

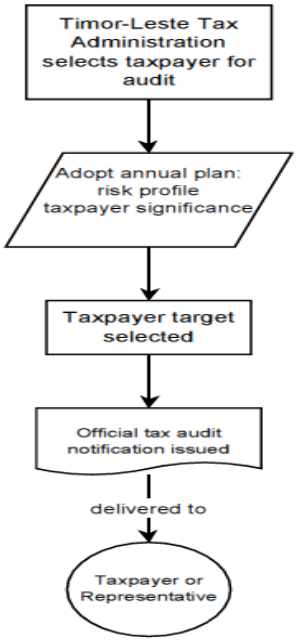
Under TDA Regulations, the sequence of a typical audit is as follows:

A tax audit is commenced with an official tax audit notification issued by the Tax Administration and delivered to a taxpayer, or the taxpayer's representatives, as the case may be. Subsequent communication is typically via an Information Document Request (IDR-Form 1000), detailing the issues under examination, the information and documents requested from the taxpayers.

A taxpayer under tax audit shall, upon a written request by the Tax Administration may be required to:

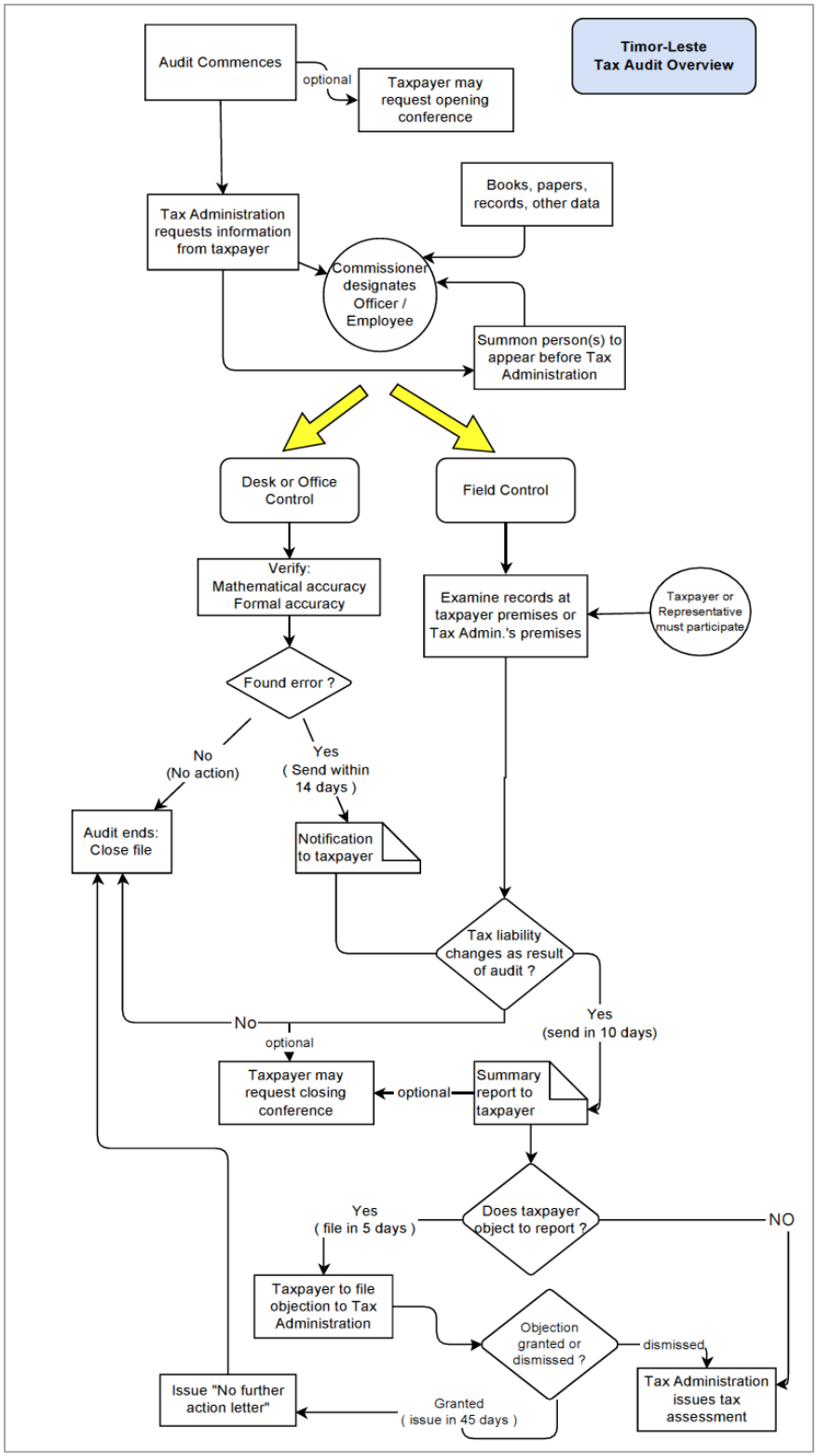
- show and or submit books and records, or copies thereof, documents and or information specifically requested by the Tax Administration and forming the basis of the book and records, documents pertaining to income received, expenditures incurred, business activities, independent work of the taxpayer or the independent work performed for the taxpayer and connected with a petroleum project, directly or indirectly

- grant access to enter such places or offices, factory, installations, platforms, Contract Area as is deemed necessary and material to carrying out the audit.



Timor-Leste taxpayer audit target selection

The following diagram shows an overview of the typical procedures adhered to in the course of a tax audit as conducted by the Timor-Leste Tax Administration. It should be emphasized that not all of the processes as shown in the diagram below are expressly provided for in the TDA Regulations on tax audit, and therefore any processes indicated in the diagram but which are not provided for in the TDA Regulations are not binding on the Tax Administration. However, it is suggested that the diagram is consistent with the current internal policy of the Tax Administration (subject to change at the discretion of the Tax Administration).


Timor-Leste
Tax Audit Overview
Audit Commences
optional
Taxpayer may request opening conference
Books, papers, records, other data
Tax Administration requests information from taxpayer
Commissioner designates Officer / Employee
Summon person(s) to appear before Tax Administration
Desk or Office Control
Field Control
Verify: Mathematical accuracy Formal accuracy
Examine records at taxpayer premises or Tax Admin.'s premises
Taxpayer or Representative must participate
Found error ?
No (No action)
Yes (Send within 14 days)
Audit ends: Close file
Notification to taxpayer
Tax liability changes as result of audit ?
No
Yes (send in 10 days)
optional
Taxpayer may request closing conference
optional
Summary report to taxpayer
Does taxpayer object to report ?
Yes (file in 5 days)
NO
Taxpayer to file objection to Tax Administration
Objection granted or dismissed ?
dismissed
Tax Administration issues tax assessment
Issue "No further action letter"
Granted (issue in 45 days)

Tax Audit in the format of Office Control

If the tax audit is conducted in the format of "Office Control", then the Tax Administration conducts the following procedures:

- verifies the accuracy, completeness, truthfulness and legal base of the data shown in tax or information returns of whatever description,
- reviews the tax balances, accounting statements and other statements or positions of the taxpayer, comparing the said data to data from tax accounting records and other official records kept by, or at the disposal of, the Tax Administration

Office controls are conducted in the premises of the Tax Administration by tax auditors or inspectors and or lawyers.

Tax Audit in the format of Field Control

If the tax audit is to be conducted in the format of "Field control", then the Tax Administration conducts the following procedures:

- examination of the taxpayer's books and records either at the taxpayer's premises or at the premises of the Tax Administration
- An examiner will check the entire return filed by the taxpayer and will examine the books, papers, records and memoranda dealing with matters required to be included in the return
- If the return presents an engineering or appraisal problem (e.g. depreciation or depletion deductions. Gains or losses upon the sale or exchange of property, or losses on account of abandonment, exhaustion, or obsolescence), it may be investigated by an engineer agent who makes a separate report

In the case where the tax audit is to be conducted in the format of a "field control", then the taxpayer has the following responsibilities and rights:

- if the field control is conducted in a premises occupied, owned, leased on controlled by the taxpayer, to designate an appropriate working area at the disposal of the tax auditors, inspectors and or their representatives
- during the field audit and during the business hours of the taxpayer, the auditors, inspectors and representatives of the Tax Administration shall have the right to enter and remain in the places designated by taxpayer for use of the tax auditors, where the taxpayer may be conducting its business
- the taxpayer or a representative with a valid power of attorney may be during the inspection of the books and records of the taxpayer by the auditors
- if the taxpayer or representative are not present and the audit progress is consequently prevented or delayed, a notation must be made in the audit record
- if the field control is not conducted in the business premises of the taxpayer, the auditors or their representatives may inspect the taxpayer's business premises and enter the report of the inspection in the audit records. In such a case, the taxpayer shall be required to participate in the fact finding process relevant to taxation in such manner so as to give information and statements at the written request of the Tax Administration
- the taxpayer is required to enable the tax auditors and their representatives to obtain copies of relevant documents and or samples of goods
- if the taxpayer is unable to attend, the taxpayer must delegate a person to act as his agent or representative to attend the audit
- the auditors and their representatives may request in writing the data or other documentation from employees of the taxpayer or other persons controlling such data or documentation
- the taxpayer's employees and persons with control of the relevant are obligated to make the information or documentation at their disposal available to the Tax Administration

- if a field control tax audit is conducted at the taxpayer's premises, it shall be conducted only during the taxpayer's working hours and exceptionally after working hours as well, if the purpose of the field control requires this and if the taxpayer consents

Taxpayer's Right to Appeal Upon Tax Assessment

The TBUCA Regulations defer to the provisions of the UNTAET Regulation 2000/18 on matters relating to appeals against tax assessments issued by the Tax Commissioner.
The following are appeals procedures which are consistent with the existing policies of the Timor-Leste Tax Administration. However, since such appeals procedures are not currently expressly provided for in the TDA Regulations, it should be emphasized that the following procedures should be regarded as "**non binding**" on the Timor-Leste Tax Administration and or the taxpayers in the context of the TDA Regulations, but are merely suggested procedures to be followed in the event of taxpayer(s)' who wish to appeal tax assessment(s):

- the notice of appeal against an assessment, reassessment or any other decision of the Commissioner shall be submitted to the Appeals Office within sixty (60) days from the day on which the assessment was delivered to the appellant
- the appeal fees (as set by the Commissioner) must accompany the notice of appeal
- Three (3) copies of the notice of appeal and any accompanying documents have to be submitted
- The notice of appeal must be signed by the appellant (i.e. taxpayer) or a representative of the appellant
- Copy of the tax assessment as issued by the Commissioner must be attached to the notice of appeal.

The notice of appeal which the taxpayer submits should contain the following information:

i. the amount as set by the respondent (ie the Commissioner) as chargeable income and amount of tax according to the tax assessment (ie. the tax amount in the tax assessment as issued)

ii. the amounts which, according to the appellant should be the correct amount of chargeable income and tax;

iii. a narrative of the factual and legal reasoning forming the basis of the Appellant's disagreement with the disputed assessment;

iv. the relief sought by the Appellant (ie. the taxpayer).

The Tax Administration will follow the following procedure:

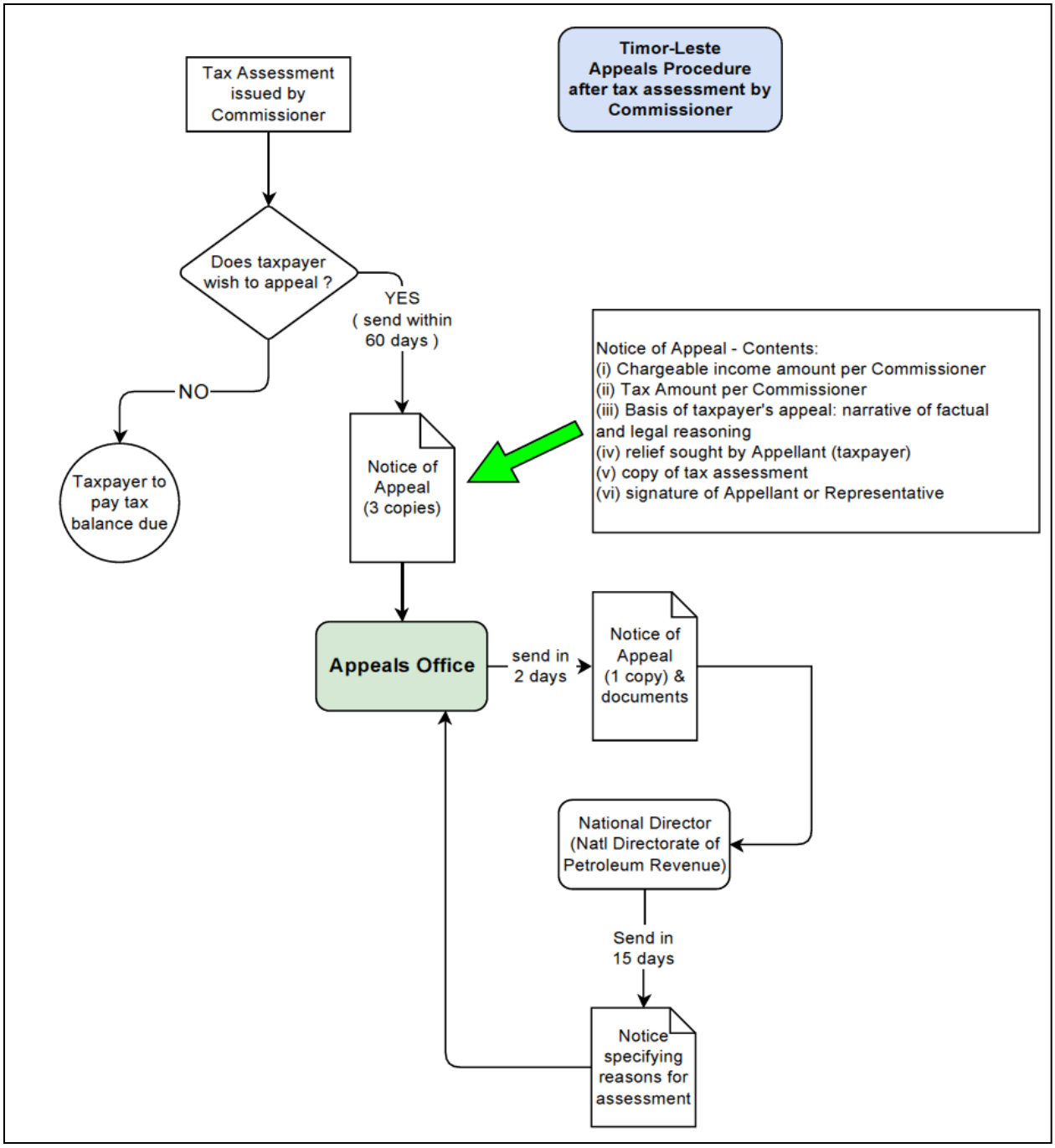
- the Appeals Office shall provide a copy of the notice of appeal and any documents received from the Appellant (ie. the taxpayer) to the National Director of the National Directorate of Petroleum Revenue within two (2) business days from the date of receipt from the Appellant

- the National Director of the National Directorate of Petroleum Revenue must submit a written notice specifying the reasons for the assessment to the Appeals Office within fifteen (15) days after receiving the notice of appeal. For this purpose, a copy of the pre-assessment letter (if any) issued to the appellant (i.e. taxpayer) and any subsequent correspondences between the National Director and or the Commissioner and the Appellant may be substituted as the written notice required.

- Where new issues are raised by the appellant other than those covered in the pre-assessment letter (if any) and other related correspondences, the Appeal office may require the National Director of NDPRM to submit a written brief in response to the appeal.

A diagram showing the suggested appeals procedure is presented below.

NOTE: The diagram below are suggested appeals procedures where taxpayer(s) wish to appeal tax assessment(s) in the context of the TDA Regulations, and are currently not binding on the Timor-Leste Tax Administration.



TBUCA Regulations*

Section 5
Applicable Laws

Summary of Pertinent Laws in the portion of the JPDA subject to the TBUCA Regulations:

- Indonesian Income Tax Law, including Minister of Finance Rulings and Directorate General of Tax (DGT) Decrees\Decisions\Circulars issued thereunder and in force on **October 25, 1999**;
- Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods;
- General Tax Regime and Procedures, as modified by the UNTAET Regulation 2000/18;
- UNTAET Regulation 1999/1;
- UNTAET Regulation 2000/18;
- Taxation of Bayu-Undan Contractors Act;
- The Tax Stability Act; and
- TBUCA Regulations/19-2012.[20]

5.5

Section 5.5 of the TBUCA Regulations performs two functions

First, it provides an exemption from taxation for the category of income described as: "in relation to income and building activities, installation and operation of an export pipeline". In other words, income derived from the operation and building of an export pipeline is exempt from taxation as described. It should be noted that the exclusion of the "operation and building" of an export pipeline" is limited only to *Contractors who are deemed to be taxpayers in Timor-Leste.* A "taxpayer" is defined under Section 4 of the TBUCA Regulations as:

"anybody, individual or corporate, who or which, pursuant to the provisions in the tax laws, is required to fulfill tax obligations (including filing of periodic information returns and registration with the Tax Administration of Timor-Leste, and who are compliant), persons required to withhold certain withholding taxes, be it income or wages-related and remit same to the Timor-Leste Tax Administration and persons who are deemed to be Contractor or Subcontractor and carrying on oil and gas business within the Annex F part of the Joint Production Development Area."

[20] *The TBUCA Regulations/19-2012 is pending the approval of the Minister of Finance.

The position of the Timor-Leste Tax Administration regarding the correct interpretation of Section 3(4) of TBUCA is that the claimant of the exception must be a *Timor-Leste taxpayer* (e.g. a Contractor as defined in Section 2 of TBUCA). In other words, if a person is engaged in a business and earns an income in connection with "building activities, installation and operation of an export pipeline" within the area subject to TBUCA, such a person will not be within the ambit of Section 3(4) except if such a person qualifies as **a Timor-Leste taxpayer**.

Example

Bing Oil Company (BOC) is a Contractor within the area subject to TBUCA. BOC is engaged in the exploitation of natural gas. BOC enters into a gas transportation agreement with another company named Trenton Gas Haulage (TGH). The agreement stipulates that TGH will build and own the pipeline to convey the gas from Bayu-Undan to a processing plant in a foreign country. BOC agrees to pay TGH a fixed monthly sum as consideration for the transportation of gas from the point of production to a processing plant located outside of Timor-Leste.

TGH is resident in foreign country and not registered with the Timor-Leste Tax Administration as a taxpayer. TGH is also not a Contractor within the meaning of that word under Section 2 of TBUCA.

The position of the Timor-Leste Tax Administration is that that the series of monthly payments made by BOC to TGH as fees for transportation services will not qualify for the Section 3(4) exclusion because TGH is neither a Timor-Leste taxpayer nor a Contractor.

Furthermore, Section 5.5 of the TBUCA Regulations also describes the types of income subject to taxation under the TBUCA Regulations, with the following definition of "Timor-Leste source income":

> An amount is Timor-Leste-source income to the extent to which the amount is connected with the performance of petroleum operations or project:
>
> (a) income from petroleum operations or project carried on by a Contractor or Subcontractor resident in Timor-Leste; or
>
> (b) by a non-resident through a permanent establishment in Timor-Leste as determined under the present Regulation and any other applicable tax laws;
>
> (c) income from the alienation of any movable property of a Contractor used in deriving Timor-Leste-source income referred to in subparagraphs (a) and (b);

(d) income from the lease of immovable property in Timor-Leste whether improved or not, or from any other interest in or over immovable property, including the right to explore for, or exploit, natural resources, in Timor-Leste;

(e) income from the alienation of any property or right referred to in paragraph (d) or from the alienation of any ownership interest in a legal person the assets of which consist wholly or principally of property or rights referred to in paragraph (d);

(f) dividend paid by a resident or permanent establishment;

(g) interest, royalties, management fees, annuity, or any other income paid by a resident or borne by a permanent establishment in Timor-Leste of a non-resident;

(h) income from services rendered in Timor-Leste relating to construction, building activities, construction consulting services, air or sea transportation, mining and mining consulting services, insofar as the remuneration is paid by a resident person or borne by a Timor-Leste permanent establishment of a non-resident person; and

(i) notwithstanding paragraphs (a)-(h), an amount taxable in Timor-Leste under an international agreement or Treaty.

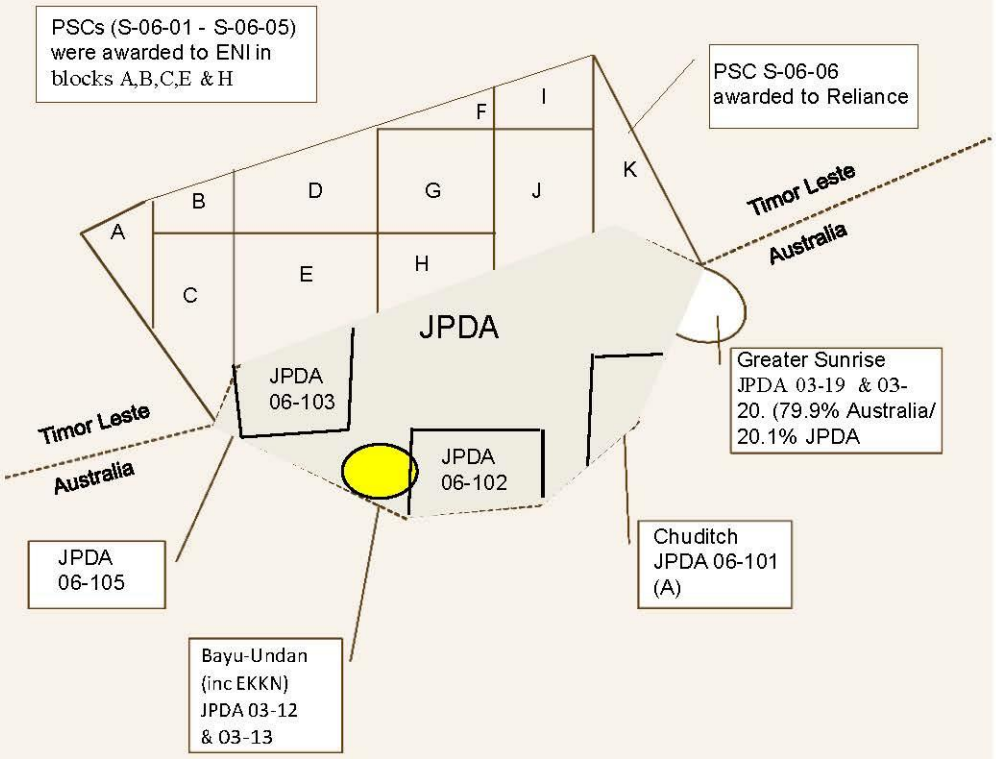
Section 5.5 must be interpreted in conjunction with the definition of the scope of the TBUCA Regulations, as stated in Section 3 (Scope of Regulations).
Under Section 3 of the TBUCA Regulations, it is specifically Production Sharing Contract ("PSC") JPDA 03-12 and JPDA 03-13 (including the amendments and annexes to these contracts, relating to natural gas) which are defined to be within the scope of the TBUCA Regulations.

In other words, a taxpayer (that is, Contractor or Subcontractor) who has income as described in the above definition of Timor-Leste source income, and which is derived in connection with the area and contracts as designated in Section 3 (Scope of Regulations), will be subject to tax on such income, or will be required to address the taxability of such income under the TBUCA Regulations. It is not to say that income outside of the scope of the TBUCA Regulations will simply not be taxed. On the contrary, such income may very well be taxed, under other applicable tax regimes (such as the Indonesian Income Tax Law regimes), and a taxpayer should refer to such other laws and tax regimes to address the taxability of such income. It is just that

the taxability of such income will be outside the domain of the TBUCA Regulations, if they fall outside the scope as defined under Section 3 (Scope of Regulations).

There are several issues of taxation in Timor-Leste impacting the portion of the JPDA that is not covered by TBUCA and the TBUCA Regulations. Section 3 of TBUCA merely provides a narrative of the applicable tax regimes but it should be noted however that in case of any conflict between a specific *provision* of TBUCA and any of the applicable regimes enumerated in Section 3, the *provision* of TBUCA prevails.

Illustration of TBUCA Sec. 3 Scope - PSC Map



This map is not to scale. It is intended for illustration only

Indicates the PSCs JPDA 03-12 & 03-13 covered by TBUCA Regulations

Example 1 (Scope of TBUCA Regulations)

Company X is a sub-Contractor providing drilling services to a Contractor T which is operating in the Bayu-Undan field, under PSC JPDA 03-12. In addition, Company X also leases construction machinery to a Timor-Leste construction Company W (unrelated to the Contractor T of PSC JPDA 03-12), and such construction company W is not engaged in any activity in the Bayu-Undan field or working on any related to PSC JPDA 03-12 or JPDA 03-13. Company W is engaged in oil and gas onshore in Timor-Leste and registered as a Contractor. Therefore, while Company X's income derived from its drilling services to Contractor T is subject to taxation under the TBUCA and TBUCA Regulations, its leasing income derived from the leasing of construction machinery to Company W is not subject to taxation under the TBUCA Regulations. Company X should refer to other tax regulations and tax regimes of Timor-Leste (such as the TDA) to determine the taxability of the leasing income derived from the leasing of construction machinery to Company W.

Income with a Timor-Leste Source by reason of a Permanent Establishment

In defining what is considered as Timor-Leste "source of income", Section 5.5 also refers to the concept of "permanent establishment" ("PE"). Permanent establishment, abbreviated as "PE", is a commonly used prevalent concept in the field of international taxation, in many countries. PE is also a concept adopted in almost all income tax treaties to determine the taxability of business profits of a non-resident enterprise (that is, a company or business which is the tax resident of one contracting country/state , doing business in another contracting country/state). It is also the concept officially adopted by the OECD (Organisation for Economic and Cooperation for Developed Countries), and also by the United Nations in its model tax convention. In contrast to the OECD model, the United Nations model is more geared towards developing countries, as opposed to developed countries[21].

In explaining what is a PE for purposes of Timor-Leste tax laws, it is therefore helpful to refer to the PE definitions of these two model conventions.

[21] The Timor-Leste treaty with Portugal, which has been signed in 2011 and is awaiting ratification, is closer to the United Nations model in its definition of a permanent establishment.

Most treaties provide that business profits (sometimes defined in the treaty) of a resident of one country are subject to tax in the other country only if the profits arise through a permanent establishment in the other country. Many treaties, however, address certain types of business profits (such as directors' fees or income from the activities of athletes and entertainers) separately. Such treaties also define what constitutes a permanent establishment (PE). Most but not all tax treaties follow the definition of PE in the OECD Model Treaty. Under the OECD definition, a PE is a fixed place of business through which the business of an enterprise is carried on. Certain locations are specifically enumerated as examples of PEs, including branches, offices, workshops, and others. Specific exceptions from the definition of PE are also provided, such as a site where only preliminary or ancillary activities (such as warehousing of inventory, purchasing of goods, or collection of information) are conducted.

While in general tax treaties do not specify a period of time for which business activities must be conducted through a location before it gives rise to a PE, most OECD member countries do not find a PE in cases in which a place of business exists for less than six months, absent special circumstances. Many treaties explicitly provide a longer threshold, commonly one year or more, for which a construction site must exist before it gives rise to a permanent establishment. In addition, some treaties, most commonly those in which at least one party is a developing country, contain provisions which deem a PE to exist if certain activities (such as services) are conducted for certain periods of time, even where a PE would not otherwise exist.

Even where a resident of one country does not conduct its business activities in another country through a fixed place or business, a PE may still be found to exist in that other country where the business is carried out through a person in that other country that has the authority to conclude contracts on behalf of the resident of the first country. Thus, a resident of one country cannot avoid being treated as having a PE by acting through a dependent agent rather than conducting its business directly. However, carrying on business through an independent agent will generally not result in a PE.

Under the OECD model tax convention, PE is defined as: "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and then it goes on to indicate that PE includes especially:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

A building site or construction or installation project
if it lasts more than twelve months.

Then, the OECD model tax convention **specifically excludes** the definition of a PE from the following:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person -- other than an agent of an independent status to whom paragraph 6 applies -- is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

In comparison, the United Nations model tax convention has the following definition of what is a PE:

Article 5
Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) A place of management;

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

(f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" also encompasses:

(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period

or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person-- other than an agent of an independent status to whom paragraph 7 applies--is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other

State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

As can be seen, the definitions of a PE under the United Nations model tax convention and the OECD 2010 model tax convention are quite similar.

In understanding the use of the PE concept in the context of Timor Leste taxation, and in particular for purposes of the TBUCA Regulations, it is important to note that the "permanent concept" is not necessarily the only concept or term being used in describing the criteria for taxation by a taxing jurisdiction around the world. Other terminology being used include: "taxable nexus", "engaged in a trade or business", "taxable presence".

For example, in the Federal tax laws of the United States, a common law jurisdiction, the term "permanent establishment" is not used at all in describing the conditions which would result in a non-resident taxpayer being subject to U.S. income taxation for certain activities, in a manner similar to the way U.S. residents are taxed (that is, subject to progressive tax rates, and being allowed to take deductions against the income, etc.). However, taken as a whole, the criteria used in many such jurisdictions, while the term "permanent establishment" is not specifically mentioned in their national tax law, are essentially equivalent to that of a permanent establishment.

Another concept which is necessary for the effective application of the permanent establishment concept is concept of "attribution" of income. Just because a non-resident company may have a

permanent establishment in Timor-Leste, does not mean all its income has a source in Timor-Leste.

Example 2 (Illustration of the Source of Income concept)

Using the same basic facts as in Example 1 above, Company X, in addition to the drilling services provided to Contractor T, it performs through a permanent establishment in Timor-Leste, it also performs engineering design services to Contractor T, through work done outside of Timor-Leste, in its home country office in Singapore. Therefore, Company X's income derived from the engineering design services performed in Singapore are not attributable to its PE in Timor-Leste, and is not sourced in Timor-Leste by because of its PE. On the other hand, it *may* nevertheless be Timor-Leste source income due to a different reason. If Contractor T is paying Company X for the engineering services in connection with PSC JPDA 03-12, Contractor T may have a withholding obligation to withhold tax on such payments to Company X (that is, withholding tax at a flat rate against the gross amount of income derived from the engineering design services. Company X may have two types income taxed differently under the TBUCA Regulations: (i) income from the drilling services as income derived through a PE, and subject to a 30% on the net taxable income (gross income less allowable expenses as deductions against taxable income), such that this income is defined as Timor-Leste source under Section 5.5 category (b), and (ii) income from the engineering design services, subject to a withholding tax on the gross receipts (i.e. flat rate imposed on the gross income, without the allowance of any deductions), which while not Timor-Leste source income as defined under the TBUCA Regulations, is nevertheless subject to withholding tax.

Income with a Timor-Leste Source by reason of a Tax Treaty

Under the TBUCA Regulations Section 5.5 (i), it is provided that: "notwithstanding paragraphs (a)-(h), an amount taxable in Timor-Leste under an international agreement or Treaty" will be included into the definition of Timor-Leste source income. It should be noted that as of the date of the preparation of these guidelines, other than the Timor Sea Treaty, there is only one other income tax treaty that Timor-Leste has signed with another tax jurisdiction (CONVENTION BETWEEN THE PORTUGUESE REPUBLIC AND THE DEMOCRATIC REPUBLIC OF TIMOR-LESTE FOR THE AVOIDANCE OF DOUBLE TAXATION AND

THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, signed September 27, 2011). It is probable that there will be more tax treaties negotiated and entered into by Timor-Leste in the near future

In the context of income tax treaties, many countries have agreed with other countries in treaties to mitigate the effects of double taxation (Double Tax Avoidance Agreement). Tax treaties may cover income taxes, inheritance taxes, value added taxes, or other taxes. Besides bilateral treaties, also multilateral countries are in place: Countries of the European Union (EU) have also entered into a multilateral agreement with respect to value added taxes under the auspices of the EU, while a joint treaty of the Council of Europe and the OECD exists and open to all nations. Tax treaties tend to reduce taxes of one treaty country for residents of the other treaty country in order to reduce double taxation on the same income. The provisions and goals vary highly; very few tax treaties are alike.

Generally, tax treaties, including the one which Timor-Leste has entered into with Portugal, perform the following functions:

- define which taxes are covered and who is a resident and eligible for benefits,
- reduce the amounts of tax withheld from interest, dividends, and royalties paid by a resident of one country to residents of the other country,
- limit tax of one country on business income of a resident of the other country to that income from a permanent establishment in the first country,
- define circumstances in which income of individuals resident in one country will be taxed in the other country, including salary, self-employment, pension, and other income,
- provide for exemption of certain types of organizations or individuals, and
- provide procedural frameworks for enforcement and dispute resolution.

The stated goals for entering into a treaty often include reduction of double taxation, eliminating tax evasion, and encouraging cross-border trade efficiency. It is generally accepted that tax treaties improve certainty for taxpayers and tax authorities in their international dealings.

Several governments and organizations have proposed model treaties to use as starting points in their own negotiations. The Organisation for Economic Co-operation and Development (OECD)

model treaty is often used as such a starting point. The OECD members have from time to time agreed on various provisions of the model treaty, and the official commentary and member comments thereon serve as a guidance as to interpretation by each member country. Similarly, the United Nations has a model income tax convention prototype which it has suggested for use by developing countries.

In general, the benefits of tax treaties are available only to persons who are residents of one of the treaty countries. In most cases, a resident of a country is any person that is subject to tax under the domestic laws of that country by reason of domicile, residence, place of incorporation, or similar criteria.

Generally, individuals are considered resident under a tax treaty and subject to taxation where they maintain their primary place of abode. However, residence for treaty purposes extends well beyond the narrow scope of primary place of abode. For example, many countries also treat persons spending more than a fixed number of days in the country as residents.[9] The United States includes citizens and green card holders, wherever living, as subject to taxation, and therefore as residents for tax treaty purposes. Because residence is defined so broadly, most treaties recognize that a person could meet the definition of residence in more than one jurisdiction (i.e., "dual residence") and provide a “tie breaker” clause.

Such clauses typically have a hierarchy of three to five tests for resolving multiple residency, typically including permanent abode as a major factor. Tax residency rarely impacts citizenship or permanent resident status, though certain residency statuses under a country's immigration law may influence tax residency.

Entities may be considered resident based on their country of seat of management, their country of organization, or other factors. The criteria are often specified in a treaty, which may enhance or override local law. It is possible under most treaties for an entity to be resident in both countries, particularly where a treaty is between two countries that use different standards for residence under their domestic law. Some treaties provide “tie breaker” rules for entity residency, some do not. Residency is irrelevant in the case of some entities and/or types of income, as members of the entity rather than the entity are subject to tax

In the context of the TBUCA Regulations, a non-resident who does not have the type of income as described in Section 5.5 (a), (c), (d), (e), (f), (h) or (i), but is nevertheless deriving income

from operating through a permanent establishment, in connection with JPDA 03-12 and JPDA 03-13, will be deemed to have Timor-Leste source income.

Two other concepts are worth mentioning on the subject of "Applicable Laws" of the TBUCA Regulations. While the TBUCA Regulations may provide specific regulations as interpretation of the TBUCA tax law, and incorporate by reference other relevant tax statutes (such as the Indonesian Law on Income Tax), taxpayers should expect that the tax administration of Timor-Leste will take the approach which will most effectively enforce its tax laws and regulations, and if necessary, may recognize substance over form, if it is discovered that the formal arrangements of the taxpayer(s) are in fact artificial and have no economic substance, and that the adoption of such formal arrangements is merely an attempt to frustrate the purpose of the Timor-Leste laws. By extension, the corporate law doctrine of "lifting the veil" may equally be extended to tax arrangements between related taxpayers where necessary to prevent the circumvention of the applicable Timor-Leste tax laws. Both principles have been applied in the past by the Timor-Leste tax administration to matters connected with capital gains under Article 11 (Alienation of property) of Annex G to the Timor Sea Treaty and in cases of transfer pricing arrangements between related parties.

Section 6
Reserve for Deactivation Costs Expenditure

Under the Regulations, a Contractor may claim a deduction for the annual amount transferred to a reserve meant to deactivate a petroleum project. The amount of the deduction is calculated in accordance with a prescribed formula. However, in order for the reserve amount to be legally taken as a deduction on the Contractor's income tax return, there must first be an "authorization" obtained in writing from the Designated Authority.

Section 6 of TBUCA Regulations provides that for the purposes of computing the taxable income for a tax year, a Contractor may deduct the annual amount transferred to a reserve

established to deactivate a petroleum project against the gross income arising from the petroleum project.

The annual amount transferred to a reserve for a tax year and allowable as deduction for a tax year under Sections 4 of the Taxation of Bayu-Undan Contractors Act and 6.1 of the present Regulations, is the amount determined for that year under a Petroleum Agreement and arising from the Total Deactivation Costs agreed upon between the Designated Authority and the Contractor or Contractors.

It is emphasized that, as a **condition precedent** to the tax deductibility of Deactivation Cost, a Contractor is required to exhibit a copy of the approval granted by the Designated Authority to the annual tax return submitted to the Commissioner and in which a claim is made for such deduction against the taxable income and or Additional Petroleum Tax. If a taxpayer's deduction amount for the Deactivation Costs exceeds the amount "**Overall Deactivation Costs Approved**", the amount of the excess shall be includible in the gross income of the Contractor in the tax year in which the excess occurs.

Under the Regulations, it is provided that the amount of Deactivation Cost deductible in a current tax year shall be calculated on the basis of the formula prescribed under Section 4(2) of TBUCA. Section 4(2) of TBUCA's formula is as follows:

> A deduction is not allowed for any decommissioning expenditure incurred by a Contractor in a fiscal year (referred to as the "current fiscal year") except to the extent that the total amount of decommissioning expenditure incurred by the Contractor in the current fiscal year and previous fiscal years exceeds the amount calculated according to the following formula:
>
> (A + B) - C
>
> Where:
>
> A is the total amount allowed to the Contractor as a deduction under sub- article 1 in the current fiscal year and previous fiscal years;
>
> B is the total amount allowed to the Contractor as a deduction under this sub-article in previous fiscal years; and

C is the total amount included in the Contractor's taxable income in the current fiscal year and previous fiscal years pursuant to sub-article 5

Therefore, the formula can be expressed as:

Decommissioning Expense Deductible =

{[Annual amount transferred to reserve to deactivate oil project] + [Deduction amount allowed in previous years]} - [Amount included in taxable income in current year, i.e. amount exceeding "Overall Deactivated Costs Approved"]

Example (Reserve for Deactivation Costs Expenditure)

ESP Ltd, Contractor, relying on a Deactivation plan approved in writing and in advance of the current tax year by the Designated Authority for the sum of $500 million as the Overall Deactivated Cost Approved. The approved Deactivation plan is for a fixed 10 year period and deductible ratably in the sum of sum of $50 million per year. In preparing its 2012 Timor-Leste income tax return, ESP Ltd deducted US$50m and exhibited a copy of the plan Decommissioning Cost Reserve approved by the Designated Authority. The Timor-Leste tax administration will in all likelihood allow the DCR tax deduction in the sum of $50 million as claimed by ESP Ltd.

Example (Reserve for Deactivation Costs Expenditure)

If the other hand ESP Ltd merely relies on a proposal submitted to the Designated Authority and without any prior approval in writing by the Designated Authority or the approved Deactivation Costs was not exhibited to the tax return, the Timor-Leste tax administration will mostly reverse the deduction claimed by ESP Ltd for the 2012 tax year.

Example (Reserve for Decommissioning Costs Expenditure)

Company T, a Contractor, relying on a Deactivation plan approved in writing and in advance of the current tax year by the Designated Authority for the sum of $500 million. The approved Decommissioning plan is for a fixed 10 year period and deductible ratably in the sum of transferred the sum of $50 million per year. Assume further that following the formula

prescribed in Section 4 of the TBUCA, the taxpayer calculated its allowable Deactivation Cost deduction to be $55 million for the 2013 tax year. The Timor-Leste tax administration will only allow the sum of $50 million as computed under the approved plan and the excess ($5 million) will be added to the 2013 gross income of Company T.

.

Section 7

Depreciation

7.1

Depreciation in general.

Generally, when a taxpayer buys a business asset that has a useful life of more than one year, the cost is usually required to be capitalized and recovered through depreciation deductions under most tax systems. On the other hand, the cost of assets with a useful life of less than one year is deducted as an expense in the tax year that their cost is incurred.

The cost of an improvement that increases the value of a property or makes it more useful, or lengthens the useful life is generally required to be capitalized and depreciated.
The tax theory or policy behind depreciation is that if a business could reduce one year's gross income by an expense deduction for the total cost of an item that is used by the business for a number of years, the result would be an understatement of net income during the years that the asset is in use. Accordingly, in order to accurately determine the net income of a business on a year-by-year basis, the cost must be allocated (i.e. depreciated) over the number of years that the asset will be considered used in the taxpayer's business. The covered period (i.e. the "tax life" of the asset) is referred to as the "recovery" or "depreciation" period. The length of the "tax life" is usually contained in the tax law or the underlying regulations.

For income tax purposes, a depreciable property is a property that is:

1. Is used in business or for the production of income;
2. has a useful life that is longer than a year, and
3. is something that wears out, decays, become obsolete, or less value from usage or natural causes.

Examples of depreciable property are automobiles, machines, and building (but not the land upon which the building is erected).

Amortization is similar conceptually to depreciation but applies only to intangible assets, such as software, patent, copyrights and trademarks.

The deduction for **depletion** is comparable to depreciation, except that the concept of depletion applies only to natural resources, such as oil and gas wells, mines, standing timber and geothermal deposits. The underlying theory of the concept of depletion is that the value of the property is declining as the natural resources is extracted or sold.

In consideration of the principle of the proper matching of income and expenses, the concept of depreciation and amortization are adopted within the generally accepted accounting principles (GAAP) in use in most modern economies. Depreciation is used as the basis to allocate the

historical cost of an asset over its useful life in order to conform with the idea that the earnings of an economic entity is matched accordingly with relative expenses including the wear and tear of the assets used in production, operations and other administrative purposes.

Thus, in measuring these fixed expenses, there are certain elements that should be taken into consideration namely historical cost, estimated useful life and residual or salvage value. Historical cost pertains to the purchase price of the asset while residual or salvage value is the expected value of the asset after its estimated usage. Likewise, estimated useful life is the time period wherein the asset is deemed economically beneficial for the economic entity.
Depreciation is the systematic allocation of a tangible's asset historical cost less its expected residual or salvage value over its estimated useful life.
Depreciation can be measured using a variety of methods the most basic of which is the straight line method. The straight line method is the simple equal allocation of the depreciable amount over the useful life. While there are other alternative methods of calculating depreciation, the TBUCA regulations adopt the straight line method of depreciation only.

Straight-line depreciation. If straight-line depreciation is used, an asset's annual depreciation expense is calculated by dividing the asset's depreciable cost by the number of years in the asset's useful life.

Calculating Straight-Line Depreciation

$$\frac{\text{Depreciable Cost}}{\text{Useful Life in Years}} = \text{Annual Depreciation Expense}$$

Another way to describe this calculation is to say that the asset's depreciable cost is multiplied by the **straight-line rate**, which equals one divided by the number of years in the asset's useful life.

Calculating Straight-Line Depreciation

$$\frac{1}{\text{Useful Life in Years}} = \text{Straight-Line Rate}$$

$$\text{Straight-Line Rate} \times \text{Depreciable Cost} = \text{Annual Depreciation Expense}$$

Suppose a company purchases a $90,000 truck and expects the truck to have a salvage value of $10,000 after four years. The depreciable cost of the truck is $80,000 ($90,000 – $10,000), and the asset's annual depreciation expense using straight-line depreciation is $20,000 ($80,000 ÷ 4).

Cost	$90,000
Less: Salvage Value	(10,000)
Depreciable Cost	$80,000

The following table summarizes the application of straight-line depreciation during the truck's five-year useful life.

Straight-Line Depreciation							
		Depreciable Cost					
Cost							$90,000
Year 1	25%	×	$80,000	=	$20,000	$20,000	70,000
Year 2	25%	×	80,000	=	20,000	40,000	50,000
Year 3	25%	×	80,000	=	20,000	60,000	30,000
Year 4	25%	×	80,000	=	20,000	80,000	10,000

At the end of year four, the $80,000 shown as accumulated depreciation equals the asset's depreciable cost, and the $10,000 net book value represents its estimated salvage value.

To record depreciation expense on the truck each year, the company debits depreciation expense–vehicles for $20,000 and credits accumulated depreciation–vehicles for $20,000.

Under Section 7.1 depreciation deductions are permissible only when the Contractor is the legal and titled owner of the asset, and the asset is in furtherance of the business activities of the taxpayer and exclusively in connection with a petroleum project. This means that the tangible asset has to be legally owned by the Contractor, with the incidents of legal ownership property include the following.

Generally speaking, incidents of ownership for purposes of the TBUCA Regulations include the following characteristics:
The Contractor possesses the following:
Legal title to the property.
Legal obligation to pay for the property.
Responsibility to pay maintenance and operating expenses.
Duty to pay any taxes on the property.
Risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion

If an asset is used for more than one petroleum project, then the cost basis of the asset cannot be depreciated for just one project, but should be prorated among the various projects.

(a) Reasonable allowance.
The Regulations provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in Section 7. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) Useful life.

For the purpose of Section 7 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination

(c) Salvage.

(1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may

represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

7.2

For purposes of Section 7.2, costs which are incurred for acquisition, construction, installations, improvements and repairs which enhance the value of assets with a use life of over one year are to be capitalized and depreciated.

7.3

For depreciation purposes, under the TBUCA Regulations, tangible assets are divided into two classes:

(a) properties with use life of 1 to 4 years
(b) properties with use life of over 4 years

7.4

The following example illustrates the application of Section 7.4

A tangible asset which is used exclusively for petroleum project was purchased at a cost of $120,000, and the useful life is estimated to be five (5) years, and the salvage value is $20,000.

Depreciation cost basis of the asset is: $100,000 = A

Applicable depreciation rate prescribed in paragraph 7.3 is 20% = B

The depreciation for a full year of use of the asset is: A x B = $100,000 x 20% = $20,000

7.5.1
In the year 2013, the first production commences on August 1, 2013.

Therefore, the number of days from the date of first production until the end of the tax year is 163 days (for the months of August, September, October, November and December 2013), so that B = 163

The total number of days in the year is 365 = C

Therefore, for the year of first production, the depreciation allowable would be:

A x B/C
A is the amount determined for a full year of depreciation, as explained under 7.4 above = $20,000
B = 163
C = 365
Therefore, the depreciation for the 2013 year (when production first commences) is:
$20,000 x 163/365 = $8,932

Section 8

Amortisation

In the context of the TBUCA Regulations, for costs incurred in the exploration and development stage of oil and gas property, and which are not for the acquisition of tangible property, such costs are categorized as the creation of "intangible asset". Then, the "intangible asset" is classified into four possible "use life" classifications, and the cost of the asset will then be amortized on a straight line basis, over the assigned use life scheme under TBUCA Regulations Section 18.. In a sense, this is very similar to the treatment of tangible property

Conceptually then, the rationale for having the amortization for the costs identified as for intangible assets is similar to that of depreciation. Amortisation is necessary in consideration of the principle of the proper matching of income and expenses, the concept of amortization is adopted within the generally accepted accounting principles (GAAP) in use in most parts of the world. Amortisation is used as the basis to allocate the historical cost of an intangible asset over its useful life in order to conform with the idea that the earnings of an economic entity is matched accordingly with relative expenses used in production, operations and other administrative purposes.

Intangible property which is subject to amortization must be property held either for use in a trade, business, or for the production of income. Because intangible assets may not necessarily be subject to "wear and tear", it is therefore purely an accounting concept adopted for the purpose of approximately matching income to the gradual write down of an intangible asset – in this case, the costs incurred for the exploration and development of the oil / gas well(s) .

Start-up expenditure

For amortization as it relates to start-up expenses for a new business or activity. Start-up expenditures are defined as investigatory expenses incurred prior to commencing a business (in this case the production of income when and oil / gas well has started successfully to produce the oil / gas output) which would have been deducted had it been paid or incurred when the taxpayer was already engaged in the trade or business activity.

8.1

The costs of determining the existence, location, extent, or quality of any mineral deposit are ordinarily capital expenditures. The costs of developing oil, gas, or geothermal wells are capital expenditures. You can usually recover them through amortization.

For costs incurred in respect of petroleum activities, other than the acquisition of tangible assets, are considered to be "intangibles". Intangibles are to be amortized in accordance to the provisions of Section 8.

For purposes of Section 8, intangibles assets include those costs incurred in the following activities: (a) exploration, (b) development and (c) those expenses which are incurred for other than acquisition of tangible assets and which have a use life of one or more years.

Examples of exploration costs are:

- costs of topographical, geological, and geophysical studies, , and salaries and other expenses of geologists, geophysical crews, and others conducting those studies
- Geological and geophysical costs
- Wages and related payroll costs in exploration activities
- Legal and professional expenses

Examples of development costs are:

- Costs to gain access to and prepare well locations for drilling, including surveying well locations
- Drill and equip development wells, development-type stratigraphic test wells
- Acquire, construct, and install production facilities
- Interest expense incurred on financing of construction
- Wages and related payroll costs in development activities
- Legal and professional expenses

8.2

For amortization purposes, intangible assets are divided into two classes:

(a) intangible assets with use life of 1 to 4 years

(b) intangible assets with use life of over 4 years

8.3

The following example illustrates the application of Section 8.3

Example

In the course of exploration of an oil well, intangible asset costs which were incurred exclusively for a petroleum project was amounted to $ 300,000, and the useful life is estimated to be three (3) years

Cost of the intangible asset is: $300,000 = A

Applicable amortization rate prescribed in paragraph 8.3 is 25% = B

The amortization for a full year of use of the intangible asset is: A x B = $300,000 x 25% = $75,000

8.4

Example

Continuing the same facts as in the Example under 8.3 above, and that in the year 2013, the first production commences on June 1, 2013.

Therefore, the number of days from the date of first production until the end of the tax year is 214 days (for the months of June, July, August, September, October, November and December 2013), so that B = 214

The total number of days in the year is 365 = C

Therefore, for the year of first production, the depreciation allowable would be:

A x B/C

A is the amount determined for a full year of depreciation, as explained under 8.3 above = $75,000

B = 214

C = 365

Therefore, the depreciation for the 2013 year (when production first commences) is:

$75,000 x 214/365 = $43,973

8.5

If the costs incurred for intangible costs had occurred before the first production date, the deduction for the amortization costs for tax purposes cannot begin until after the date of first production. For example, if the costs in the example in 8.4 above were incurred during the year 2012 in the amount of $300,000, but the first production commences on June 1 2013, no deduction would be allowed for amortization for the 2012 tax year. A deduction of amortization for the intangible costs will only be allowed beginning for the year 2013, and as computed on a pro-rated basis as explained in 8.4 above.

Section 10
Inventory

Introduction

The use of inventories at the start and close of each year is required in most every case where production, purchase or sale of merchandise is an income-producing event or factor. Inventories are required to be used where necessary to clearly reflect income and must conform to the best practices in the industry or trade of the affected taxpayers[22].

The term inventory is used to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Depending on the nature of the company's operations, inventories can include raw production materials, work in process, finished goods, and/or merchandise inventory. In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. Gross profit from business operation is calculated by subtracting from receipts the cost of goods sold. The cost of goods sold is

[22] Section 10.1(a) and (b) of TBUCA Regulations.

determined by adding the inventory at the beginning of the year to the cost of goods purchased or produced during the year and subtracting from this total the inventory at the end of the year.

The use of accrual basis and inventories more clearly reflects the income of a single accounting period through recognition of unsold goods on hand at the beginning and end of each tax year.

An inventory is an itemized list, with valuations of good held for sale or consumption during manufacturing or merchandising business. Taxpayers are required to clearly verify the amount of items in the inventory by physical count of the items as of the last day of the year. Taxpayers may also use estimates of inventory shrinkage that are confirmed by physical count after year-end if the taxpayer normally does a physical inventory count at each location on a regular and consistent basis and the taxpayer makes proper adjustments to such inventories and to its estimating methods to the extent such estimates are greater than or less than the actual shrinkage.

The balance in this account is also affected by accounting methods. In order to correctly match revenue to expenses, it is necessary to have an accounting methodology which can track the costs of inventory, as costs of the company are incurred to procure or produce the merchandise, which is then eventually sold to the customer at a profit. However, in recognition of the fact that a company may not sell all of its merchandise produced within a single accounting period, and that some of the finished products can still remain on hand at the end of the accounting period (for example, oil or gas which have been extracted from wells, but which are not yet sold within the same year in which the products have been extracted).

Accounting standards permit various acceptable inventory measurement methods, including last-in-first-out (LIFO), first-in-first-out (FIFO), weighted average, and specific identification. An inventory must conform to the best accounting practice in the particular trade or business and it must clearly reflect income. As a rule of thumb, an inventory method selected under the best accounting practice, that can be used in a balance sheet showing the financial position of the taxpayer will generally be regarded as clearly reflecting income by the Timor-Leste tax administration.

The term inventory is used to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of

production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this balance is determined by the process of pricing the articles comprised in the inventory.

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

The balance in this account is also affected by accounting methods. In order to correctly match revenue to expenses, it is necessary to have an accounting methodology which can track the costs of inventory, as costs of the company are incurred to procure or produce the merchandise, which is then eventually sold to the customer at a profit. However, in recognition of the fact that a company may not sell all of its merchandise produced within a single accounting period, and that some of the finished products can still remain on hand at the end of the accounting period (for example, oil or gas which have been extracted from wells, but which are not yet sold within the same year in which the products have been extracted)

Accounting standards permit various acceptable inventory measurement methods, including last-in-first-out (LIFO), first-in-first-out (FIFO), weighted average, and specific identification. Specific identification has been used most frequently for inventories in which the separate items are distinct and have a high cost, because the benefit to be gained from tracking these individual items is high. For lower-cost items in inventory, the value of such specific tracking is low

unless a company is using sufficiently sophisticated databases that allow detailed inventory tracking to be readily accomplished.

Even if a company uses sophisticated technology to control inventory, the accounting measures do not have to reflect precise physical flows, as would occur using specific identification. Rather, the LIFO, FIFO, and weighted average methods refer to assumptions that are made about the flow of inventory through the company. Using LIFO, the costs of the oldest inventory are maintained on the balance sheet under the assumption that the most recently acquired inventory is sold first. Using FIFO, the company assumes that the first goods sold are the oldest and the most recently acquired items remain in inventory on the balance sheet. The weighted average method uses average costs over the reporting period to calculate the inventory balance. The effect of accounting choices on the income statement and balance sheet is presented below. The LIFO method has been excluded as a method which should be used under the IFRS (International Financial Reporting Standards), and the TBUCA Regulations has also accordingly excluded the use of the LIFO method for taxation purposes.

Method	Assumption	Income Statement Effect	Balance Sheet Effect
FIFO	When a company sells an item from inventory, the oldest one is sold	The older inventory was cheaper, so cost of sales is less and income is higher	The remaining inventory carried on the balance sheet is the newest, and most valuable
LIFO	When an item is sold from inventory, the newest one is sold	The newer (more expensive) inventory is sold, so the cost of sales is higher and income is lower	Remaining inventory is shown as an older and less valuable asset
Average cost	The average cost of all inventory is used for both cost of sales and inventory	Both cost of sales and income will be between the levels recorded under LIFO or FIFO	Inventory asset will be between the levels recorded under LIFO or FIFO

10.2
Under the TBUCA Regulations, inventories are to be valued at cost or market, whichever is lower. Where inventories are valued at cost by the taxpayer, then the cost shall be determined using the absorption-cost method. See 10.3 below for explanation of the absorption-cost method.

The designation under the TBUCA Regulations of the principle as the accounting valuation method for inventory of "lower of cost or market" ("LCM") is a recognition of the conservatism principle widely followed by principle economies of the world. In this method the term "market" includes both the market in which the company purchases its merchandise as well as the market in which it sells its merchandise. The lower of cost or market rule as the lower of cost or replacement cost–with certain limitations placed on the replacement cost amount.

As used in the phrase lower of cost or market, the term market means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(3) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(4) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

10.2.2
Inventory Costing Methods

Under the TBUCA Regulations, the taxpayer has a choice of the following inventory accounting methods:

d. Specific identification
e. First in First Out (FIFO)
f. Weighted average

If a taxpayer (Contractor) is able to specifically identify particular items of inventory, it may do so and use the first method: specific identification. However, if the taxpayer is unable to specifically identify the inventory units then either the FIFO (first-in-first-out) method or the

weighted average cost method may be used to compute the cost of inventory at the end of a tax period.

The Specific Identification Method

Overview

The specific identification method is the tracking and costing of inventory based on the movement of specific, identifiable inventory items in and out of stock. This method is applicable when individual items can be clearly identified, such as with a serial number, stamped receipt date, or RFID tag.

Specific Identification Method Requirements

The principle requirements of a specific identification tracking system are:

Be able to track each inventory item individually. The easiest method is a durable metal or paper label that contains a serial number. Alternatively, a radio frequency identification tag can contain a unique number that identifies the product.

Be able to track the cost of each item individually. The accounting system should clearly identify the cost of each purchased item, and associate it with a unique identification number.

Be able to relieve inventory for the specific cost associated with an inventory item when it is sold.

These requirements can be achieved with a simple accounting system, possibly just an electronic spreadsheet, which makes it applicable to smaller businesses.

The specific identification method introduces a high degree of accuracy to the cost of inventory, since the exact cost at which something was purchased can be recorded in the inventory records, and charged to the cost of goods sold when the related item is sold.

However, this method is not widely used, because there are few purchased products that are clearly identified in a company's accounting records with a unique identification code. Thus, it is typically restricted to unique, high-value items for which such differentiation is needed.

Most organizations instead sell products that are essentially interchangeable, and so are more likely to use a FIFO, LIFO, weighted average, or similar system.

It is also very time-consuming to track inventory on an individual unit basis, which restricts its use to smaller inventory quantities.

FIFO (first-in-first-out) Inventory method

Overview of the First-in, First-out Method

The first in, first out (FIFO) method of inventory valuation operates under the assumption that the first goods purchased are also the first goods sold. In most companies, this accounting assumption closely matches the actual flow of goods, and so is considered the most theoretically correct inventory valuation method.

Under the FIFO method, the earliest goods purchased are the first ones removed from the inventory account. This results in the remaining items in inventory being accounted for at the most recently incurred costs, so that the inventory asset recorded on the balance sheet contains costs quite close to the most recent costs that could be obtained in the marketplace. Conversely, this method also results in older historical costs being matched against current revenues and recorded in the cost of goods sold, so the gross margin does not necessarily reflect a proper matching of revenues and costs.

The FIFO method is allowed under both Generally Accepted Accounting Principles and International Financial Reporting Standards. The FIFO method provides the same results under either the periodic or perpetual inventory system.

Example 1 (First-in, First-out Method)

M Corporation decides to use the FIFO method for the month of January. During that month, it records the following transactions:

	Quantity Change	Actual Unit Cost	Actual Total Cost
	+100	$210	$21,000
Sale	-75		
Purchase (layer 2)	+150	280	42,000
Sale	-100		
Purchase (layer 3)	+50	300	15,000
Ending inventory	= 125		

The cost of goods sold in units is calculated as:

100 Beginning inventory + 200 Purchased – 125 Ending inventory = 175 Units

M's controller uses the information in the preceding table to calculate the cost of goods sold for January, as well as the cost of the inventory balance as of the end of January.

	Units	Unit Cost	Total Cost
Cost of goods sold			
FIFO layer 1	100	$210	$21,000
FIFO layer 2	75	280	21,000
	175		$42,000
Ending inventory			
FIFO layer 2	75	280	$21,000
FIFO layer 3	50	300	15,000
	125		$36,000

Thus, the first FIFO layer, which was the beginning inventory layer, is completely used up during the month, as well as half of Layer 2, leaving half of Layer 2 and all of Layer 3 to be the sole components of the ending inventory.

Note that the $42,000 cost of goods sold and $36,000 ending inventory equals the $78,000 combined total of beginning inventory and purchases during the month

With first-in, first-out, the oldest cost (i.e., the first in) is matched against revenue and assigned to cost of goods sold. Conversely, the most recent purchases are assigned to units in ending inventory.

Example 2 (First-in, First-out Method)

The following information is used to calculate the value of inventory on hand at the end of the tax year on December 31 and cost of goods sold during December in a FIFO inventory system (using a "periodic costing system").

Dec 1	Beginning Inventory	60 units @ $15.00 per unit
5	Production	140 units @ $15.50 per unit
14	Sale	190 units @ $19.00 per unit
27	Production	70 units @ $16.00 per unit
29	Sale	30 units @ $19.50 per unit

Computation of inventory costs

FIFO Periodic

Units Available for Sale	= 60 + 140 + 70	= 270
Units Sold	= 190 + 30	= 220
Units in Ending Inventory	= 270 − 220	= 50

Cost of Goods Sold	**Units**	**Unit Cost**	**Total**
Sales From Dec 1 Inventory	60	$15.00	$900
Sales From Dec 5 production	140	$15.50	$2,170
Sales From Dec 27 production	20	$16.00	$320
	220		**$3390**

Ending Inventory	**Units**	**Unit Cost**	**Total**
Inventory From Dec 27 production	50	$16.00	$800

Weighted Average Inventory method

The weighted-average method relies on average unit cost to calculate cost of units sold and ending inventory. Average cost is determined by dividing total cost of goods available for sale by total units available for sale.

When using the weighted average method, the cost of goods available for sale is divided by the number of units available for sale, which yields the weighted-average cost per unit. In this calculation, the cost of goods available for sale is the sum of beginning inventory and net purchases. You then use this weighted-average figure to assign a cost to both ending inventory and the cost of goods sold.

Weighted average costing is commonly used in situations where:

- Inventory items are so intermingled that it is impossible to assign a specific cost to an individual unit.
- The accounting system is not sufficiently sophisticated to track FIFO inventory layers.
- Inventory items are so commoditized (i.e., identical to each other) that there is no way to assign a cost to an individual unit.

The net result of using weighted average costing is that the recorded amount of inventory on hand represents a value somewhere between the oldest and newest units purchased into stock. Similarly, the cost of goods sold will reflect a cost somewhere between that of the oldest and newest units that were sold during the period.

Example 1 (Weighted Average method)

M Corporation elects to use the weighted-average method for the month of May. During that month, it records the following transactions:

	Quantity Change	Actual Unit Cost	Actual Total Cost
Beginning inventory	+150	$220	$33,000
Sale	-125	--	--
Purchase	+200	270	54,000
Sale	-150	--	--
Purchase	+100	290	29,000
Ending inventory	= 175		

The actual total cost of all purchased or beginning inventory units in the preceding table is $116,000 ($33,000 + $54,000 + $29,000). The total of all purchased or beginning inventory units is 450 (150 beginning inventory + 300 purchased). The weighted average cost per unit is therefore $257.78 ($116,000 ÷ 450 units.)

The ending inventory valuation is $45,112 (175 units × $257.78 weighted average cost), while the cost of goods sold valuation is $70,890 (275 units × $257.78 weighted average cost). The sum of these two amounts (less a rounding error) equals the $116,000 total actual cost of all purchases and beginning inventory.

In the preceding example, if M Corporation used a perpetual inventory system to record its inventory transactions, it would have to recompute the weighted average after every purchase.

The following table uses the same information in the preceding example to show the recomputations:

	Units on Hand	Purchases	Cost of Sales	Inventory Total Cost	Inventory Moving-Average Unit Cost
Beginning inventory	150	$ --	$ --	$33,000	$220.00
Sale (125 units @ $220)	25	--	27,500	5,500	220.00
Purchase (200 units @ $270)	225	54,000	--	59,500	264.44
Sale (150 units @ $264.44)	75	--	39,666	19,834	264.44
Purchase (100 units @ $290)	175	29,000	--	48,834	279.05

Note that the cost of goods sold of $67,166 and the ending inventory balance of $48,834 equal $116,000, which matches the total of the costs in the original example. Thus, the totals are the same, but the moving weighted average calculation results in slight differences in the apportionment of costs between the cost of goods sold and ending inventory.

Example 2 (Weighted Average Method)

The S Company incurred $306 for 270 units, producing an average cost of $1.13333 per unit ($306/270). The ending inventory consisted of 120 units, or $136 (120 X $1.13333 average price per unit). The cost of goods sold was $170 (150 units X $1.13333 average price per unit).

10.3

The full absorption costing method of inventory valuation costing is required under the regulations, **if inventories are valued at cost by the taxpayer**.

Full absorption costing is a costing system which treats all costs of production as product costs, regardless weather they are variable or fixed.

The theoretical justification for absorption costing is to adopt the matching principle for all production costs. Fixed production overhead costs are only incurred with the expectation that the resources represented by these costs will be used in the production of inventory. Hence, these costs should be matched against the revenue generated from the sale of that inventory.

Absorption costing requires computing an overhead rate for applying all manufacturing overhead to units produced during the period (or else two overhead rates, one for variable manufacturing overhead and one for fixed manufacturing overhead; or else multiple overhead rates if the company uses activity-based costing). There are important issues related to choosing the denominator in the overhead rate for fixed manufacturing overhead.

The cost of a unit of product under full absorption costing method consists of direct materials, direct labor and both variable and fixed overhead. Full absorption costing allocates a portion of fixed manufacturing overhead cost to each unit of product, along with the variable manufacturing cost.

Example (Full Absorption Costing Valuation method)

The M Company produces a product has the following cost structure.

Number of units produced 6,000

Variable costs per unit:

Direct materials $2

Direct labor $4

Variable manufacturing overhead $1

Variable selling and Administrative expenses $3

Fixed costs per year:

Fixed manufacturing overhead $30,000

Fixed selling and administrative expenses $10,000

Computation of the unit product cost under full absorption costing method

Direct materials $2

Direct labor $4

Variable manufacturing overhead $1

Total variable production cost $7

Fixed manufacturing overhead $5

Unit product cost, as computed under the full absorption cost method = $12

Section 11

Withholding Tax

A withholding tax, is a requirement of the Timor Leste government for the payer of an item of income to withhold or deduct tax from the payment, and pay that tax to the Tax Administration at the Ministry of Finance of the Timor Leste government.

In Timor-Leste, as in many other jurisdictions, withholding tax applies to specified categories of income. Many jurisdictions also require withholding tax on payments of interest or dividends. Governments use withholding tax as a means to combat tax evasion, and sometimes impose additional withholding tax requirements if the recipient has been delinquent in filing tax returns, or in industries where tax evasion is perceived to be common.

In certain cases, the withholding tax is treated as a payment on account of the recipient's final tax liability. It may be refunded if it is determined, when a tax return is filed, that the recipient's tax liability to the government which received the withholding tax is less than the tax withheld, or additional tax may be due if it is determined that the recipient's tax liability is more than the withholding tax. In some cases the withholding tax is treated as discharging the recipient's tax liability, and no tax return or additional tax is required.

The substantive TBUCA Regulations on withholding tax requirements are as follows:

11.1 Royalty or similar payment **paid to a resident taxpayer** or **permanent establishment** in respect of any petroleum project: 5.4 % (90% x 6.0% = 5.4%)

11.2 Royalties, rent, income connected with the use of property, compensation for services, work and activities **paid to a non-resident taxpayer other than** a **permanent establishment** in Timor-Leste and in respect of any petroleum project: 7.2% (90% x 8% = 7.2%)

11.3 Compensation or remuneration paid to dependent non-resident employees, for services connected with a petroleum : 18% (90% x 20% = 18%)

11.4 Net income of a permanent establishment carrying on petroleum and natural gas exploration (drilling) activities in respect of a petroleum project : 5.40% (90% x 6% = 5.4%)
= basis for the monthly tax installment payments prescribed under Section 25 of the Law on Income Tax

11.5 Net income of a permanent establishment providing shipping or air transportation services in respect of a petroleum 2.16% (90% x 2.4% = 2.16%)
= basis for the monthly tax installment payments prescribed under Section 25 of the Law on Income Tax

The TBUCA Regulations withholding tax rates can be illustrated in the following table.

Type of Activity	TBUCA W/H tax rate (without 10% reduction)	TBUCA W/H tax rate (with 10% reduction)	Final Tax ? Yes / No
Royalties to residents or PE	6.0%	5.4%	No
Royalties to non-residents (non- PE)	8.0%	7.2%	Yes
Compensation or remuneration to dependent non-resident employees	20%	18%	Yes
Net income of PE	6%	5.4%	No
Shipping or air transportation services of PE	2.4%	2.16%	No

11.1

Example
S Company, a Contractor at the Bayu-Undan field, has an agreement with T Company. Under the agreement, T Company provides a license to S Company for a proprietary technology in oil field operations. S Company pays a $2,000 monthly license fee to T Company for the use of the

technology. T Company has an office in Dili, Timor Leste, and it is through the Dili office that T Company entered into the agreement with S Company.

As the $2,000 monthly license fee paid by S to T is considered to be a royalty, and T is a resident of Timor Leste for tax purposes, S has to withhold 5.4% (being 6%d of 90%) of the gross royalty amount of $2,000 paid to T as withholding tax, or $108 on a monthly basis.

11.2

Example

Using the same facts as the example in 11.1 above, except that T Company is a non-resident of Timor Leste and does not have a permanent establishment (as defined under the definition of "permanent establishment" in ETRS Public Ruling 2001-11, paragraph 6).

In this case, S has to withhold 7.2% (being 8% of 90%) of the gross royalty amount of $2,000 paid to T as withholding tax, or $144 on a monthly basis.

11.3

Example

The P Company is a sub-Contractor performing clean up services in the Bayu-Undan field. P Company employed three (3) temporary employees working in Bayu-Undan for a period of four (4) months, with each of the employees earning US$6,000 per month, totaling $18,000 for the three employees for each of the four months. The three temporary employees are non-residents of Timor-Leste for income tax purposes, under the definitions provided in Section 4 of the TBUCA Regulations. (In other words, they were not present in Timor Leste for 183 days or more during the tax year.)

P Company is required to withhold 18% on the compensation paid to each of the employees in the amount $1,080 per month (18% x $6,000 = $1,080), aggregating $3,240 for the three employees for each month. The withheld tax should be reported by the P Company on the withholding tax forms and remitted to the Timor Leste NDPR on a monthly basis, for the four months the employees were employed during the tax year.

Example

Boston Engineering Service (BOSTON) was hired by a Contractor in the Bayu-Undan field to plug an abandoned well, which BOSTON completed in 30 days. BOSTON is a non-resident of Timor Leste for income taxes, under the definitions provided in Section 4 of the TBUCA Regulations and does not have a permanent establishment in Timor Leste. (In other words, BOSTON does not have a permanent establishment ("PE") in Timor Leste, under the definition of PE in ETRS Public Ruling 2001-11, paragraph 6.)

Under the contract (the original contract) Boston is to perform the work (plug an abandoned well) using its employees who are non-residents of Timor Leste for the 30 days work period.
The Contractor also entered into a separate contract to reimburse expenses incurred by BOSTON for additional work without any provision for a mark-up.
Under the original contract, the Contractor has to withhold tax at 7.2% (being 8% of 90% of the gross amount) of the service fees paid by Contractor to BOSTON.
Under the additional separate contract, because there is no mark-up on the expenses being invoiced by BOSTON, the amounts paid by the Contractor under this separate contract is not subject to income tax withholding.

Section 12
Obligations of a Person Withholding Tax From a Payment

In the Law on Income Tax and also TBUCA, there are various legal requirements for Timor-Leste taxes to be withheld by the payor on gross income amount(s) owed to the recipient(s). These are referred to as "withholding tax" obligations.
To properly discharge the withholding tax obligations under these tax regulations, the payor (that is, including a Contractor or sub-Contractor) are required to:

- Remit the tax withheld within fifteen (15) days after the month end (of the month that the payment was made by the payor to the payment recipient)

- The withheld tax is to be paid over to Timor-Leste Central Bank, crediting its Petroleum Fund Account

- Issue a "withholding tax notice" to the payment recipient, stating the following information: (i) amount of the gross income amount owed to the recipient, (ii) tax withheld from such gross income amount

To encourage prompt payment of withheld Timor-Leste taxes, the government of Timor-Leste has adopted the "trust fund tax" concept, similar to that in many other countries, regarding the withheld taxes. These taxes are called trust fund taxes because the payor are considered to hold the money (the tax imposed on the gross amount of income owed and paid to the payment recipient) in trust on behalf of the recipient and the Timor-Leste government until the payor make a tax deposit in that amount with the Timor-Leste Central Bank. That is why, under the Regulations, a Contractor or Subcontractor who fails to withhold tax in accordance with law is personally liable to pay the amount of the tax which has not been withheld. Accordingly, the payor (that is, the Contractor or Subcontractor, who is obligated to withhold tax) is treated as an "agent" of the Timor-Leste Tax Administration, to the extent of the taxes required to be withheld. The Tax Administration takes the position that if a payment was made by a payor to a recipient and the taxes were not withheld as required, then both the payor and recipient are held jointly and severally liable for such unpaid taxes.

Who Can Be Responsible for the Liability of Taxes which were required to be withheld, but which were in fact not withheld?

The liability of taxes required to be withheld, but were in fact not withheld by the payor, can be charged personally against any person who:

- Is responsible for collecting or paying withheld income and taxes, or for paying collected taxes, and
- Negligently or willfully fails to collect or pay them.

A responsible person is a person or group of people who has the duty to perform and the power to direct the collecting, accounting, and paying of the taxes. This person may be:

- An officer or an employee of a corporation,
- A member or employee of a partnership,
- A corporate director or shareholder,
- A member of a board of trustees of an organization,
- Another person with authority and control over funds to direct their disbursement,
- Another corporation or third party payer,
- Payment service providers (PSP), such as a payroll service company or a bookkeeping company or responsible parties within a PSP
- Responsible parties within the common law employer (client of PSP/PEO).

For the liability to be imposed, it is sufficient that the responsible person:

- should have been aware of the outstanding taxes and
- either intentionally disregarded the law or was plainly indifferent to its requirements (no evil intent or bad motive is required).

For example, using available funds to pay other creditors when the business is unable to pay the withheld taxes is an indication of willfulness.

Example (Section 12 - Obligations of a Person Withholding Tax From a Payment)

Company J is a Subcontractor operating in the Bayu-Undan oilfield, through a permanent establishment there. For the month of June 2013, Company J had a payroll compensation of $80,000 with employees who are classified as dependent non-resident employees, for services they provided. Under the applicable regulations, Company J is required to withhold 18% tax (being 20% of 90% of the gross amount) on the $80,000 of payroll compensation, or $14,400. Company J did in fact withhold $14,400 of taxes from their employees for June 2013, and paid the employees $65,600 of net amount, after deducting the $14,400 of taxes imposed.

However, instead of remitting the $14,400 of withheld taxes to the Timor-Leste Central Bank, Company J used the $14,400 to pay a company to purchase a jeep for the company's general manager, Mr. R Smith. It was the general manager who authorized this payment and was the one who signed the check to pay for the jeep.

Under the Regulations, both Company J and R. Smith, the general manager are held responsible for the liability of the $14,400 of withheld taxes. R. Smith, being a responsible person, is personally liable for the $14,400 to the Government of Timor-Leste.

Section 13

General

Deductibility- A taxpayer, whether a corporation, an individual, a partnership, a trust, or an estate, generally, may deduct from gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred in the tax year. However, a deduction is generally not permissible for any expenditure that is capital in nature. An expense that adds to the value or useful life of an asset is considered a capital expense.

The origin and character of an expense are usually the controlling factors in the determination of whether an expense is deductible business expense or nondeductible personal expense. Whether an expense is ordinary and necessary is based upon the facts and circumstances surrounding the expense. The bright light or safe harbor adopted by the Timor-Leste tax administration is that an expense is necessary it is appropriate and helpful to the taxpayer's business.

In general, expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. An expense is ordinary if it is one that is common and expected in the particular business activity. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income.

Among the items included in business expenses are management expenses, commissions, labor (i.e. wages and salaries), supplies, incidental repairs, operating expenses of equipment used in the trade or business, traveling expenses, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. Such costs and expenses incurred to acquire tangible property or intangible property, such costs should be capitalized. See Sections 17 and 18 of the TBUCA Regulations.

The full amount of the allowable deduction represents the total amount of ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

13.1
Non-Deductible Expenses in respect of Income Tax

Under TBUCA Regulations, in determining the taxable income of an income taxpayer, the following types of payments cannot be deducted:

(a) distribution of profits such as dividends and by whatever name called or form;
(b) penalties of any kind, penal or administrative;

Explanation:
No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to any government agency, regardless if it is a government agency of Timor Leste or the government of a foreign country.

Definition. For purposes of this section a fine or similar penalty includes an amount—

(i) Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime in a criminal proceeding;

(ii) Paid as a civil penalty imposed by any governmental agency, including those imposed by the Tax Administration, Commissioner of Taxation, as additions to tax and additional amounts and assessable penalties and interest, due to the underpayment, or late payment of taxes

(c) excessive compensation paid by a legal person for work performed and paid to shareholders or related parties as compensation;
(d) incentives, pension fund payments, and insurance premiums for personal interest and/or the families of expatriate employees, management and shareholders;
(e) losses arising from a transaction with a related party where transactions were determined

by the Commissioner not to be at arm's-length;

(f) costs incurred for the benefit of a related party or shareholders;

(g) bad debts;

(h) exploration and development costs incurred before the commencement of commercial production and which are required to be capitalized;

- These costs should be capitalized as intangible costs (unless they relate to the acquisition of tangible property), and then amortized under Regulations Section 18

(i) reserves, other than approved deactivation cost reserve under Section 4 of the Taxation of Bayu-Undan Contractors Act;

(j) salaries paid to members of an association, limited or unlimited partnerships without share capital;

(k) costs incurred by a Contractor and not in connection with a Contract Area as defined under the relevant Production Sharing Contract;

- The costs incurred by a Contractor or Subcontractor which relate to projects outside of the JDPA are not deductible

(l) if an income taxpayer is required to withhold tax from a payment that is deductible as necessary and ordinary business expense of the taxpayer, including payment of wages, the deduction is not allowed until the taxpayer pays the withheld tax to the Tax Administration;

- For the regulations on the requirements and mechanics of payment of withholding tax, please refer to Regulations Section 11 and 12.

(m) a fine or other monetary penalty imposed for violation of any law, rule or regulations; (n) a bribe or any similar amount;

(o) an expenditure or loss incurred to the extent recoverable under a policy of insurance or contract of indemnity;

(p) the acquisition costs of an asset having a useful life of more than one (1) year;

(q) payments made by a permanent establishment to a head office or related party as royalties or other similar compensation in connection with property, patents or other similar rights;

(r) compensation in connection with management services between related parties; (s) gifts, donations, aid

(t) interest payments made by a permanent establishment to a head office or related party except when connected with a debt or loan from a bank and directly connected with a petroleum project in Timor-Leste and approved by the Designated Authority;

(u) the following payments made by permanent establishment to a head office or related party:

1) long-term corporate planning expenses;
2) policy making costs;
3) public and government relations costs
4) finance\treasury related expenses
5) advertising, donations, sponsorship;
6) entertaining expenses;
7) legal and other professional fees;
8) intra-group relations costs; and
9) any payments whatsoever failing to meet the requirements and conditions stipulated in KEP-62

Example (Section 13 – Non-Deductible Expenses in respect of Income Tax)

Company X performs services in Timor-Leste, using the branch form, and is deemed to have a PE (permanent establishment) in Timor-Leste. Based on financial statements as prepared by Company X's accountant (which, according to such accountant was prepared according to generally accepted accounting principles ["GAAP"]), the PE generated a profit of US$65,000 for the tax year 2013. Upon review of the financial statements, it was discovered that one of the expenses deducted was a US$150,000 "management fee" paid by the PE to the head office. Such $150,000 management fee will be disallowed under Section 13(r), and because it is a disguised profit payment to the head office under 13(a). Alternatively, it may be disallowed if instead of operating as a branch, Company X organizes a separate subsidiary and that subsidiary operates in Timor-Leste as a PE. If the requirements of Section 13(u)(9) are not met, the Timor-Leste Tax Administration may reject the deduction.

Example (Section 13 – Non-Deductible Expenses in respect of Income Tax)

Company D has filed its tax year 2013 tax return. Upon audit, it was determined by the Commissioner of Taxation that certain of the Company D tax deductions on its tax return are not deductible, and accordingly the Commissioner issued an assessment of underpayment of tax against Company D, in the amount of US$1,000, plus an underpayment of tax penalty in the amount of $250. Company D may not deduct the $250 tax penalty in the computation of its taxable income for any of its tax periods, for purposes of tax returns to be filed with the government of Timor Leste.

Example (Section 13 – Non-Deductible Expenses in respect of Income Tax)

A sub-Contractor with a PE in Timor-Leste Bayu-Undan provides oil well maintenance services to a Contractor who is drilling oil under PSC JPDA 03-12. However, during the tax year 2013, the Contractor's employees were sent to perform services for a period of four (4) months to a Contractor who is working under PSC JPDA 03-20 in the Greater Sunrise area. Accordingly, the a portion (one third) of the compensation costs (salaries and wages, related payroll costs) of the sub-Contractor should be computed and allocated outside of the costs used to compute its taxable income for purposes of the TBUCA Regulations. In other words, one third of the compensation expenses incurred by the sub-Contractor should be disallowed under TBUCA Regulations Section 13.1(k).

Example (Section 13 – Non-Deductible Expenses in respect of Income Tax)

Company I has a PE in Timor Leste, and is providing services in Bayu-Undan oil field. During the tax year 2013, it incurred a loss valued at US$500,000 in an accident. After submitting an insurance claim to its insurance carrier company, the insurance company informed Company I that it will likely reimburse Company I an amount of US$430,000 for its loss, however, the reimbursement payment will only be paid to Company I in January 2014. Therefore, for the tax year 2013 tax return, Company I will be able to deduct an amount of US$70,000 for its accidental loss. The balance of the loss of $430,000 will be disallowed as a deduction, since that amount should be recoverable by Company I from its insurance company.

13A

Substantiation

Under the TBUCA Regulations, a trade or business expense will not qualify for deduction unless the taxpayer is able to substantiate the expense. To substantiate a business deduction, the taxpayer must possess proof of the amount of the payment and provide evidence establishing the character of the expense.

Proof of Payment

There are several ways to establish that a payment was in fact made.

A canceled check can serve as proof of payment.

Also acceptable are account statements prepared by a financial institution that show:

A check clearance if the statement also indicates the check number, the amount of the check, the date the check amount was posted to the account, and the name of the payee.

An electronic funds transfer if the statement also indicates the amount of the transfer, the date the transfer was posted to the account, and the payee.

A credit card charge if the statement also shows the amount of the charge, the date of the charge, and the payee.

In cases the taxpayer is unable to prove payment by providing a canceled check or an account statement, the Tax Administration will generally require other evidence of payment of an amount, such as the combination of an invoice marked "paid," a check register or carbon copy of the check, and an account statement showing the date, check number, and amount of the expense.

Additional Requirements

The taxpayer will need more than proof of payment to establish an entitlement to a deduction for a business expense. Receipts, charge slips, sales slips, signed invoices, payment acknowledgments, check registers, and carbon copies of checks are all examples of items to retain to help substantiate the character and deductibility of the business expense.

Example (Section 13A – Substantiation)

The taxpayer purchased various services from a Contractor, who provided (i) cleaning out the debris of a renovation of the office for US$1,500, and (ii) performed landscaping in the garden of the office building for US$2,800, and (iii) sold a cleaning equipment to the taxpayer for US$2,000. The Contractor listed all three items on one invoice, with the details listed, and prices for each item, and a total of $6,300. Since the three items are for separate items, the taxpayer can deduct the expenses under the *de minimis* rule, without having to provide proof of payment, even though the total of the three items exceed US$5,000.

Section 13B

Disallowance of Unsubstantiated Business Expenses

Under TBUCA Regulations Section 13B, the tax administration may disallow the amount claimed as business deductions for Timor-Leste taxation purposes, if the substantiation requirements of Section 13A of the TBUCA Regulations are not met.

In addition, Section 13B provides for the following requirements:

- Any person, or any person required to file a return of information with respect to income under the applicable tax laws as stated in Section 3.1 of TBUCA, other than an individual wage earner, shall keep such permanent books of account or business record, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any tax return or information.
- The books or records required by this shall be kept at all times available for inspection by authorized Tax Administration officers or employees and or third party agents, and shall be retained so long as the contents thereof may become material in the administration of any applicable tax laws in Timor-Leste.
- All records required by the TBUCA Regulations shall be kept, by the person required to keep them, at one or more convenient and safe locations in Timor-Leste, accessible to the Tax Administration officers, employees and or authorized agents, and shall at all times be available for inspection by the Tax Administration.

From the perspective of the fair and efficient administration of the tax regulations of Timor-Leste, it is imperative that the books and records of the taxpayers are well kept, that such records be kept for a reasonably sufficiently long period, and that the records be kept in Timor-Leste.

Example (Section 13B - Disallowance of Unsubstantiated Business Expenses)

Company G has its headquarters in Country A, and operates in the Bayu-Undan oilfield, through a permanent establishment ("PE") . While it has some accounting records (such as cash

disbursement ledgers) in Timor-Leste, Company G maintains the general ledger and has shipped most of the business receipts and original financial documents to the head office in Country A. This would be a violation of TBUCA Regulations section 13B.

Section 14
Transfer of Rights or Stakes in a Petroleum Project

The purpose of Section 16 of the TBUCA and Section 14 of the TBCA Regulations are:

1. Discourage "loss trafficking" , and
2. preserve the tax basis of the assets transferred by the transferor to the transferee.

This section of the TBUCA Regulations addresses the taxation issues when an interest (right, stake) in a petroleum project is transferred or disposed of by a Contractor.

Under the Regulations, a Right or Stakes in a Petroleum Project is deemed to be transferred or assigned **in whole** by a Contractor where one of the three (3) following situations occur:

- 100% of the voting rights or value of the Contractor is transferred or sold directly or indirectly, to another person, including an entity controlled by the Contractor or controlling the Contractor
- all or substantially all of the assets of the Contractor is sold or transferred to another person
- where a statutory or de facto merger, acquisition, reorganization, amalgamation, liquidation, change of name followed by or preceded by transfer of more than 50% of the voting shares or value of the Contractor to another person

Then, the Regulations provide that, where there is "**continuity of business purpose**" of the transferor Contractor, the transferee Contractor shall "succeed to the balance of deferred tax asset of the transferor Contractor and continue to amortise any Exploration or Development Expenditure in the manner and on the same basis as the original transferor Contractor".

For the purposes of these Regulations, "**continuity of business purpose**" is defined as where the transferee Contractor is engaged immediately after the transfer of a Petroleum Agreement in an actively conducted trade or business which has been so conducted under the transferred Petroleum Agreement throughout the five-year period ending on the date of the transfer by the transferor Contractor in Timor-Leste.

Where a Contractor's right or stakes in a Petroleum Operation is **partially transferred** or assigned to another Contractor, then:

- The acquiring Contractor shall be deemed to have succeeded into the gross revenues and incurred the deductible expenses equal to the percentage of the right or stakes transferred or assigned by the transferor Contractor, immediately before the occurrence of the transfer or assignment; and

- For the purposes of determining the accrued net revenues of the acquiring Contractor in the tax year in which the transfer or assignment occurred, the accrued net revenues of the transferor or assigning Contractor at the close of the tax year immediately preceding the year of the transfer or assignment, shall be multiplied by the "percentage transfer factor". For this purpose, the term "percentage transfer factor" is defined in Section 4 of the TBUCA Regulations.

    - "**Percentage transfer factor**" is explained as follows:
      the percentage of the right or stake held by the transferring or assigning Contractor, in a petroleum project, which is either transferred or assigned, divided by the total percentage of the right or stake held by the transferring or assigning Contractor in the petroleum project immediately before the occurrence of the transfer or assignment

Example (Section 14 - Transfer of Rights or Stakes in a Petroleum Project – Definition of "percentage transfer factor")

Company X, a Contractor in the Bayu-Undan oil field, owned the right to extract oil under PSC JPDA 03-12 June 1st 2013, for 10% of the project. Then, on June 2nd 2013, Company X transferred 2% of the right to extract oil under PSC JPDA 03-12 to Company Y, so that after the transfer, Company X then owned 8% of the right to extract oil under PSC JPDA 03-12. The "percentage transfer factor" in this situation is: 20% (computation: 2% / 10% = 20%).

While TBUCA Regulations Section 14 provides for rules on how a transferee Contractor is to succeed to certain tax characteristics of a transferor Contractor after the transfer of right or stakes in a Petroleum Project, it does not directly address the taxability of the "transfer" itself.

The taxability of a transfer of all or part of a Contractor's interest or stakes in a Petroleum Project is actually addressed by TBUCA Regulations Section 5.5 (e).

Under TBUCA Regulations Section 5.5 (e) provides that income from the alienation of:

(iii) any property or right referred to in TBUCA Regulations Section 5.5 (d)
or

(iv) any ownership interest in a legal person the assets of which consist wholly or principally of property or rights referred to in TBUCA Regulations Section 5.5 (d).

is considered to be Timor-Leste source income.

The property or rights referred to in TBUCA Regulations Section 5.5 (d) is defined as either:

(c) income from the lease of immovable property in Timor-Leste whether improved or not,
or

(d) from any other interest in or over immovable property, including the right to explore for, or exploit, natural resources, in Timor-Leste;

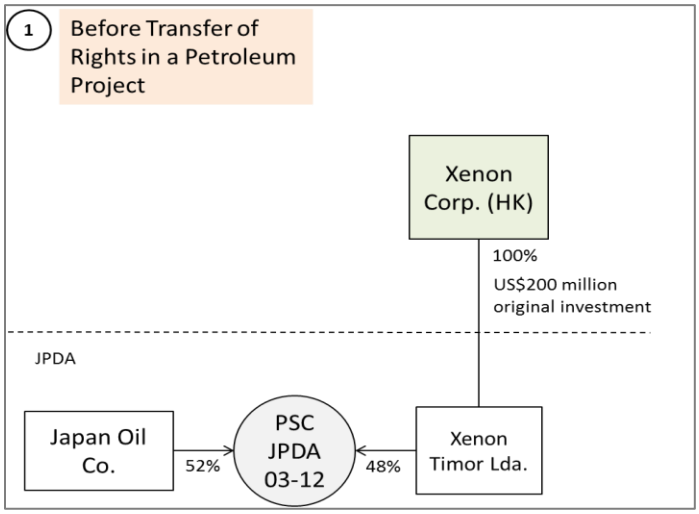
Therefore, if a Contractor sells / transfers in exchange for valuable consideration the right to explore or exploit natural resources (such as a petroleum or gas field), then it is selling / transferring the property or rights as defined in TBUCA Regulations Section 5.5(d), and is therefore considered to have derived Timor-Leste source income, and which is taxable under Timor-Leste tax laws.

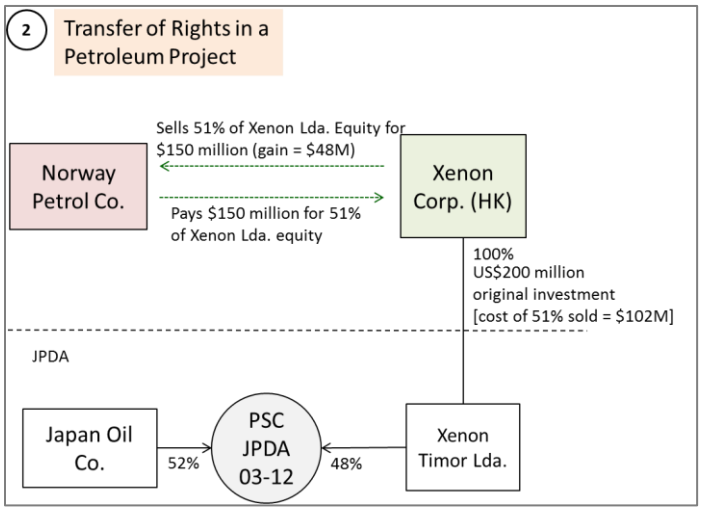
Notice that TBUCA Regulations Section 5.5(e) refers to the income from the alienation of "any ownership interest" in a Section 5.5(d) right or property, and classifies such income as Timor-Leste source income. It does not require a transfer of a complete (i.e. 100%) ownership held by the transferor.

Therefore, if a Contractor, as a legal person, owns a certain percentage of the right or stakes in a petroleum project (which is certainly within the definition of TBUCA Regulations Section 5.5(d) as a" right to explore for, or exploit, natural resources, in Timor-Leste), and all or a portion of the equity interest of the Contractor (i.e. as a legal person) is being sold or transferred for valuable consideration, then this would be considered as Timor-Leste source income for purposes of TBUCA Regulations Section 5.5 (e), and therefore would be subject to income tax under Timor-Leste tax law.

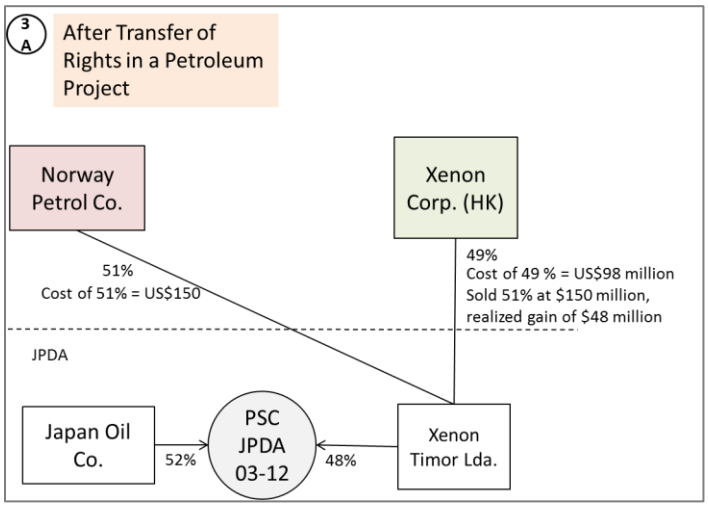
Example (Section 14 - Transfer of Rights or Stakes in a Petroleum Project – Taxability of transfer of equity in)

Xenon Corp. , a Hong Kong company, owns 100% of Xenon Timor Lda., a Contractor which has a 48% stake of the right to exploit petroleum in Bayu-Undan, under PSC JPDA 03-12. Xenon Corp had invested US$200 million to capitalize Xenon Timor Lda. , allowing Xenon Timor Lda to acquire its 48% stake. Then, Xenon Corp. agreed to sell 51% of the equity of Xenon Timor Lda. to an unrelated company, the Norway Petrol Co., for $150 Million





Then, after the sale / transfer, Xenon Corp. will own 49% of Xenon Timor Lda.

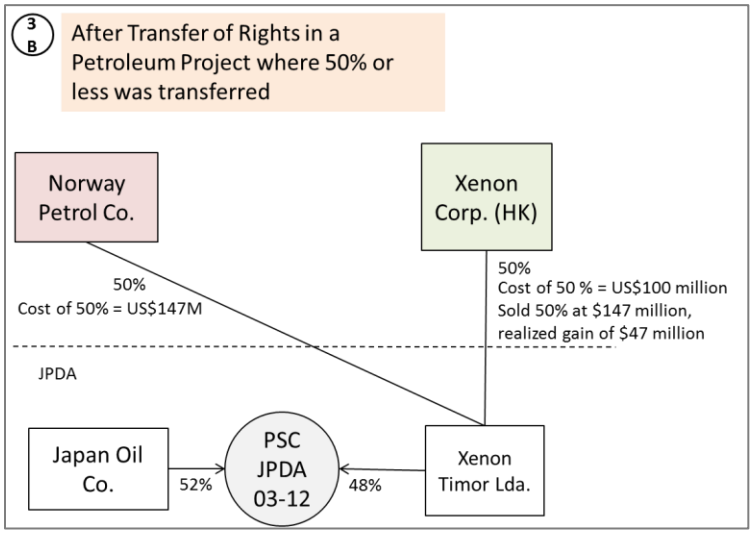


Because Xenon Corp. has realized income (in this case, a gain of $48 million) from the alienation of an ownership interest (i.e. the 51% equity) in a legal person (Xenon Timor Lda.) with assets consisting principally of rights referred to in TBUCA Regulations Section 5.5 (d) (i.e. the right to exploit oil, a natural resource, in Timor-Leste), then Xenon Corp. has realized Timor-Leste source income in the amount of $48 million, which is subject to income tax under Timor-Leste tax law.

Even in the ownership interest of Xenon Timor Lda. being sold is not the majority interest (i.e. not exceeding 50%); the result should be the same. See diagram below. Under TBUCA Regulations, the sale of "**any ownership interest**" will result in the income realized to be classified as Timor-Leste source income, as there is no requirement that the ownership interest being sold to be a controlling or majority interest for the sourcing rule to apply.

It should be noted that the principle expressed above, of taxing the sale of an ownership interest of a legal person, which owns the right to exploit natural resources, is very much consistent with international taxation principles which are widely adopted in the world. When a legal person (such as a corporation, partnership, or other types of legal entities) owns mostly real estate as its assets, a commonly recognized and adopted taxation principle is that the country where the real estate is located should have the legal right to impose income tax on the income / gain realized from the sale of the equity of such a legal entity (legal person). For this purpose, real estate is typically interpreted to include natural resources or the rights to exploit it.

For this purpose, real estate is typically interpreted to include natural resources or the rights to exploit it. This theory is consistent with the interpretation adopted by the Timor-Leste tax administration in respect of Article 11 of Annex G to the Timor Sea Treaty.
Therefore, if the end result is as described in the diagram below in, the taxation treatment will not differ from the one above.



Chapter II

Section 15
Annual Income Tax Return

15.1

Due Date of Annual Income Tax Return

Since for most taxpayers the tax year is a calendar year from 1st January to 31st December, the due date of the annual income tax return will be on 31st March of the year following the end of the tax year on 31st December.

Example 1

Company A uses the calendar year as its tax year. For the tax year ended 31st December 2013, the annual income tax return of Company A will be due on 31st March 2014.

When the due date prescribed under the Regulations for filing a tax return (or for performing any act under the Regulations) falls on a Saturday, Sunday, or legal holiday, then the due date or the act shall be considered performed timely if performed on the next succeeding day which is not a Saturday, Sunday, or legal holiday. For this purpose, any authorized extension of time shall be included in determining the last day for performance of any act.

Legal holidays. For the purpose of these Regulations, the term legal holiday includes the legal holidays as published by the Prime Minister of Timor Leste.

In order to be considered as timely filed, the tax return must be actually received by the Tax Administration on or before the due date of the tax return. While the taxpayer may use mail, express delivery courier services or private delivery services, the taxpayer assumes the risk of using such delivery methods, and the taxpayer must ensure that the tax return is actually received in a timely manner by the Tax Administration in order for the tax return to be considered as : (a) filed and (b) delivered in a timely manner.

Place of filing of annual income tax return

Unless otherwise notified by the Ministry of Finance, annual income tax returns of taxpayers subject to the TBUCA regulations are to be delivered to the Tax Administration at the following address:

National Directorate of Petroleum and Mineral Revenue
Ministry of Finance
Palacio do Governo
Building No. 5
Av. Presidente Nicolau Lobato
P.O. Box 18
Dili, Timor Leste

15.2

Example 2
Company Y submitted its 2013 year tax return. Despite having significant related party transactions meeting the threshold for the inclusion of certain transfer pricing documentations during 2013, it failed to exhibit such information to its tax return as filed to the Tax Administration of Timor Leste. Company Y is deemed not to have filed a complete tax return for the 2013 year, and can be subject to administrative penalties under the Regulations.

15.4

Extension of Time to File Tax Return

In applying for an extension of time to file the annual income tax return under Section 15, the taxpayer (Contractor or Subcontractor) must make the request in writing, with such request delivered to the Tax Administration on or before the date of the regular due date for filing such tax return.

The application for extension of time to file tax return must be submitted in writing, and is required to contain the followings:

1. Name and address of the taxpayer
2. Tax identification number of the taxpayer
3. Year for which the last tax return was filed by the taxpayer
4. Year for which the extension is being requested for
5. (a) Total estimated tax for the tax year, (b) estimated taxes paid to date, (c) amount of tax payment accompanying the extension application, (d) proof of the payment of 100% of the estimated tax for the year
6. The requested period of extension beyond the regular due date of the tax return (not to exceed six (6) months)
7. Reason(s) for the extension request
8. Signature of taxpayer's representative and date

Upon receipt of the extension request, the Tax Administration will review such request and inform the taxpayer as to whether such request has been approved or denied. The request for an extension to file informational return is routinely granted by the Timor-Leste Tax Administration.

Upon receipt of notification from the Tax Administration of an approval for the extension, the taxpayer is to file the income tax return by the new extended due date.
If the Tax Administration has denied the request, the taxpayer must file the tax return within ten (10) days of the date of notification.

Example 3

Company B, in determining that it is unable to complete and file its 2013 tax return by the regular due date of 30th March 2014, submitted on 15th March 2014, a request to the Commissioner of Taxation for an extension of time to file its tax return for a period of three months. In its application, the Company B enclosed a payment of US$18,000 as the balance of estimated tax payment so as to pay its estimated 2013 tax liability in full. On 25th March 2014, the Commissioner of Taxation notified Company B that it was granted an extension period of two months to file its 2013 tax return. Company B must file a complete and accurate income tax return to the Tax Administration by 31st May 2014.

Example 4

In the example above, Company B, having submitted its request on 15th March 2014 for an extension of time to file its 2013 tax return, failed to enclose its payment of $18,000 of the balance of its 2013 estimated tax. Accordingly, on 31st March 2014, Company B still owes $18,000 of tax and has only paid 75% of its estimated tax liability for 2013. On 25th March 2014, the Commissioner of Taxation notified Company B that its request for extension of time to file tax return has been denied. Company B must submit its 2013 tax return and any outstanding tax payment to the Tax Administration by 5th April 2014. Company B will be subject to a late payment penalty for failure to pay 100% of its 2013 year tax when due on 31st March 2014, up until its tax was actually paid on 5th April 2014.

Chapter IV

Section 25
Allocation and Reallocation of Income and Expenditures among Related Parties and or Associates / Anti-avoidance Rules & Policies

Under the TBUCA Regulations, Section 25 and 26, the Commissioner has authority to reallocate or reapportion income, deductions credits or allowances among related parties and /or associates. These TBUCA Regulations sections essentially embody the substantive transfer pricing rules under the Timor-Leste tax regime. To understand and effectively apply these TBUCA Regulations in the reallocation or reapportioning of income, deductions as between related parties, it is necessary to have a basic understanding of the concepts of transfer pricing. To provide the background for the understanding of the Timor-Leste rules on transfer pricing, a synopsis of the basic concepts are stated below.

Rationale and Objectives of Transfer Pricing Rules in the TBUCA Regulations

Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world.

A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called “intra-group” transactions. In addition, transactions involving intangibles and services constitute a rapidly growing proportion of an MNE’s commercial transactions and have greatly increased the complexities involved in analyzing and understanding such transactions.

The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the interests of the entities of a group.

In such a situation, it becomes important to establish the appropriate price, called the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services. Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. "Transfer pricing" therefore refers to the setting of prices for transactions between associated enterprises the transfer of property or services. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between companies that are not associated and can be assumed to operate independently ("on an arm's length basis") in reaching terms for such transactions.

"Transfer pricing" thus does not necessarily involve tax avoidance as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration of Timor-Leste, just as the tax administration of other jurisdictions, may consider this to be "mispricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise.

Consider a profitable company group in country A that buys "oil well drilling machinery bits" from its own subsidiary in country B: how much the parent company in country A pays its subsidiary company in country B (the "transfer price") will determine how much profit the country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm's length price, the country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed machinery is sold.

From the perspective of the tax authorities, country A's tax authorities might agree with the profit reported at their end by the machinery group in country A, but their country B counterparts may not agree - they may not have the expected profit to tax on their side of the operation. If the machinery company in country A bought its drilling bits from an independent company in country B under comparable circumstances it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or

subsidiary, whichever is in a low- tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimising its tax incidence.

When the various parts of the organisation are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct arm's length price, or at least an "arm's length range" of prices needs to be arrived at.

A possible reason for associated entities charging transfer prices for intra-group trade is to measure the performance of the individual entities in a multinational group. The individual entities within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the entities. However not every entity would necessarily make a profit or loss in arm's length conditions. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an associated entity if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. Prices should on this basis gravitate towards the so-called "arm's length price", the transaction price to which two unrelated parties would agree.

While the above explanation of transfer pricing sounds logical , arriving at an appropriate transfer price may be a complex task particularly because of the potential difficulties in identifying and valuing intangibles transferred and / or services provided. For example, intangibles could be of various different types such as: industrial assets like patents, trade types, trade names, designs or models, literary and artistic property rights, know-how or trade secrets. Sometimes such intangibles are reflected in the accounts and sometimes not. Thus, there are many complexities involved which have to be taken into account while dealing with transfer pricing in cross-border transactions between MNE entities.

In business economics a transfer price is considered as the amount that is charged by a part or segment of an organisation for a product, asset or service that it supplies to another part or segment of the same organisation.

It is in recognition of the above reasons that the tax regime of Timor-Leste has adopted the concepts and rules as embodied in the TBUCA Regulations, so as to be able to determine the fair apportionment of a taxpayer, which is a MNE (multi-national enterprise) which does business in Timor-Leste.

Basic issues underlying Transfer Pricing

Transfer prices serve to determine the income of two or more entities of a MNE (multi-national enterprise) involved in the cross-border transaction. The transfer price therefore tends to shape the tax base of the countries involved in cross-border transactions.

In any cross-border tax scenario, the parties involved are the relevant entities of the MNE group along with the tax authorities of the countries involved in the transaction. When one country's tax authority (such as Timor-Leste) adjusts the profit of a member of the MNE group, this may have an effect on the tax base of another country (for example, if the member whose profit is being adjusted by Timor-Leste has a transaction with a related party, in say, Malaysia, then the profit of such related party in Malaysia can be correspondingly affected). In other words, cross border tax situations involve issues related to jurisdiction, allocation of income and valuation.

The key jurisdiction issues are which government should tax the income of the group entities engaged in the transaction, and what happens if both governments claim the right to the same income. If the tax base arises in more than one country, should one of the governments give tax relief to prevent double taxation of the relevant entities' income, and if so, which one?

An added dimension to the jurisdictional issue is motivation for transfer pricing manipulation as some MNEs engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through non-arm's length transfer pricing in order to reduce the aggregate tax

burden of a multinational group. It may be noted that the reduction of taxation may be a motive influencing an international enterprise in the setting of transfer prices for intra-group transactions, but it is not the only factor contributing to the transfer pricing policies and practices of an international enterprise.

The aim of non-arm's length transfer pricing in such cases is usually to reduce a multinational group's worldwide taxation. This can be achieved by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under-charging or over- charging the associated entity for intra-group trade. For example, if a company (Co. 1) an international MNE group has a tax rate in a country of 30% (such as the tax rate in Timor-Leste) and it has a related entity (Co. 2) resident in another country with a tax rate of 20%, then Co.1 may have an incentive to shift profits to its related entity (Co. 2) to reduce its tax rate on these amounts from 30% to 20%. This may be achieved by the Co. 1 (the one deriving significant income in Timor-Leste) being over-charged for the acquisition of property and services from its related entity (Co. 2).

While the most obvious motivation may be to reduce an international enterprise's worldwide taxation, other factors may influence transfer pricing decisions, such as imputation of tax benefits in a company's country of residence.

A further motivation for an international enterprise to engage in such practices is to use a tax benefit, such as a tax loss, in a jurisdiction in which it operates. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. In some cases an international enterprise may wish to take advantage of an associated company's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying forward tax losses by an associated company, the international enterprise has an incentive to use the losses as quickly as possible. In other words profits may sometimes be shifted to certain countries in order to obtain specific tax benefits.

From the perspective of Timor-Leste, similar to other taxing jurisdictions, the allocation of

costs and income from the MNE resources needs to be addressed to calculate the tax. It is not uncommon, and this reality is certainly recognized by the government of Timor-Leste, that there sometimes can be disputes between countries in the allocation of costs and resources owing to their objective of maximising the tax base in their respective nation states.

Mere allocation of income and expenses to one or more members of the MNE group is not sufficient; the income and expenses must also be *valued*; a key issue of transfer pricing is therefore the valuation of intra-group transfers.

With the MNE being an integrated structure with the ability to exploit international differentials and to utilise economies of integration not available to a stand-alone entity, transfer prices within the group are unlikely to be the same prices that unrelated parties would negotiate.

Therefore, transfer pricing rules are essential for countries, including the tax regime of Timor-Leste, in order to protect their tax base, to eliminate double taxation and to enhance cross border trade. For Timor-Leste, transfer pricing rules are essential to provide a climate of certainty and an environment for increased cross-border transactions with other countries, while at the same time ensuring that the Timor-Leste tax administration is being deprived of its fair share of revenue.

Use of the "arm's length principle" under Timor-Leste TBUCA Regulations

Consistent with the approaches adopted by the OECD, the United Nations, and most other tax jurisdictions, the Timor-Leste government, as reflected in the TBUCA Regulations, uses the "arm's length principle" as the guiding principle in establishing an acceptable "transfer price" between associated enterprises (that is, related parties).

Under the arm's length principle, transactions within a group are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices. Thus, the marketplace comprising independent entities is the measure or benchmark for verifying the transfer prices for intra-entity or intra-group transactions and their acceptability for taxation purposes.

The rationale for the arm's length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities. Under the arm's length principle, intra-group transactions are tested and may be adjusted if the transfer prices are found to deviate from comparable arm's length transactions.

An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in a similar manner. However this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may be provided with an incentive to avoid taxation through transfer pricing manipulation.

While it is relatively easy to describe the arm's length principle, establishing guidelines on the practical application of the principle is a complex task as its practical application requires identification and application of reliable comparable transactions.

The following example describes a situation where the arm's length principle needs to be applied:

- Assume a corporation P (parent) manufactures diamond drill bits (for oil wells operations) in country A, sells the finished drill bits to its subsidiary S in country B which then uses the drill bits in providing services to unrelated parties. In such a case S's taxable profits are determined by the depreciation taken of the drill bits to the unrelated parties, based on the purchase price paid for the drill bits to its parent corporation.

If country A where the seats are manufactured has a tax rate lower than the tax rate in country B where the drill bits are being used for services to unrelated parties, then perhaps corporation P would have an incentive to book as much profit as possible in country A and to this end show a very high sales value (or transfer price) of the drill bits to its subsidiary S in country B. On the other hand, If the tax rate was higher in country A than in country B then the corporation would

have an incentive to show a very low sale value (or transfer price) of the drill bits to its subsidiary S in country B and concentrate almost the entire profit in the hands of country .B

The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case corporation P and its subsidiary S) are appropriately priced to reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

The underlying concept for the arm's length principle is to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create.

Applying the arm's length principle

The process to arrive at the appropriate arm's length price typically involves the following processes or steps:

a) Comparability analysis;
b) Evaluation of transactions;
c) Evaluation of separate and combined transactions;
d) Use of an arm's length range or central point in the range;
e) Use of multiple year data;
f) Losses;
g) Location savings and location rents;
h) Intentional set-offs; and
i) Use of customs valuation.

Definition of "Associates" / "related parties" under TBUCA Regulations

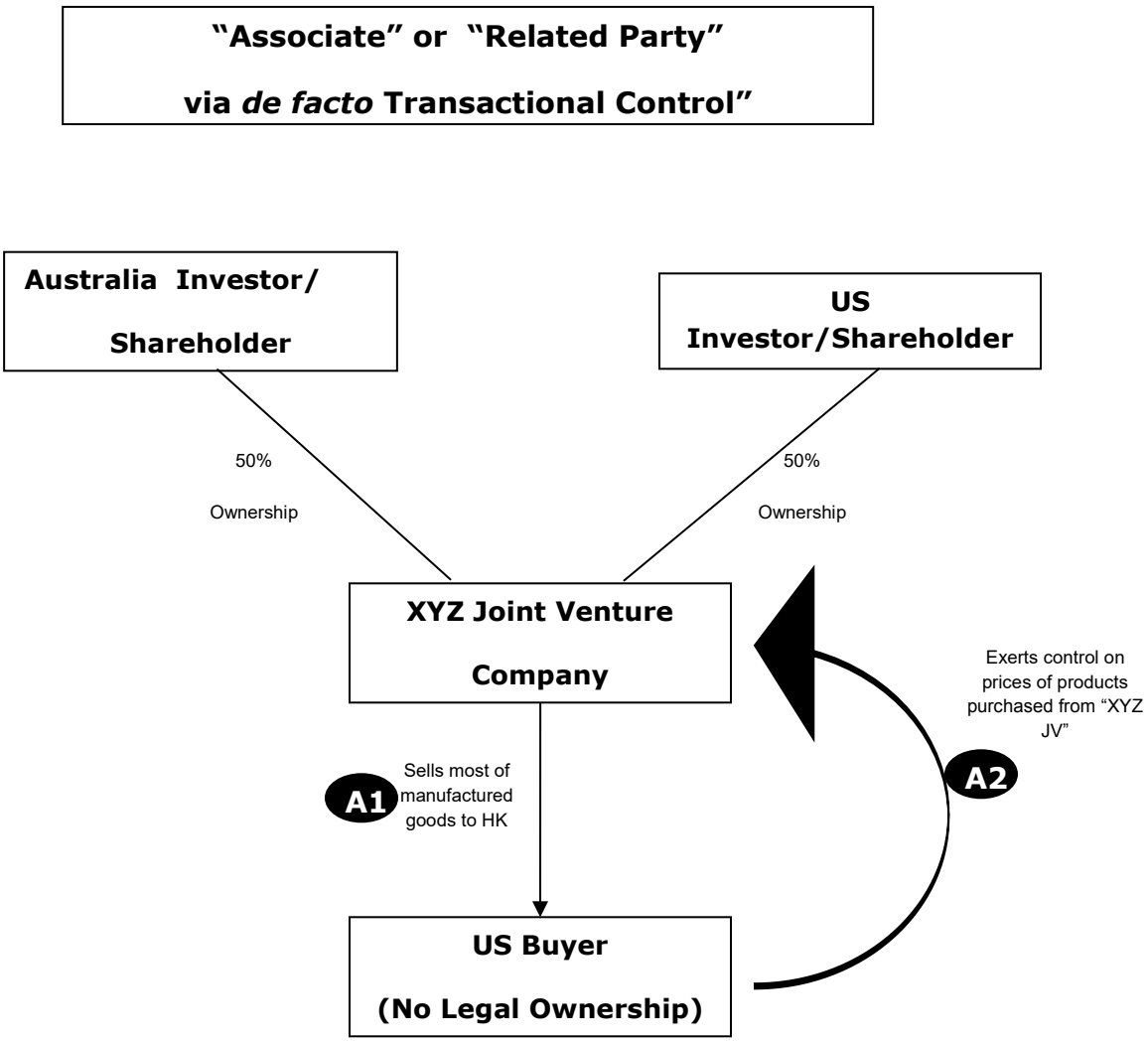
The term "Associate" has the following definition under TBUCA Regulations, Section 4:

"Associate" in relation to a person means any other person who acts or is likely to act in accordance with the wishes of the person as a result of a connection between the persons or common ownership or control; it includes:

c) A natural person and a relative of the natural person;
d) A legal person and any person who owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in the legal person; or
c) Two or more legal person if a third owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in each person;

It should be noted that even if two persons, such as two corporations, are not under the direct or indirect common control of 50% or more of their capital or voting rights, they can still be considered as "associates" or "related parties" for purposes of the TBUCA Regulations if one party has *de facto* control of another party, if one party will likely to act in accordance with the wishes of the other party. This type of *de facto* control can be illustrated by the example below.

Example



A1	:	XYZ JV sells most of the its products to US buyer.
A2	:	US Buyer exerts effective control over prices charged by XYZ JV on products sold to buyer.
Result	:	XYZ JV and US buyer can be considered "related parties" even though there is no legal ownership between them.

Chapter IV
Section 26
Transfer Pricing Methods in Connection with Transfer of Properties

This part of the Regulations describes several transfer pricing methods that can be used to determine an arm's length price and describes how to apply these methods in practice. Transfer pricing methods or methodologies are used to calculate or test the arm's length nature of prices or profits. Transfer pricing methods are ways of establishing arm's length prices or profits from transactions between associated enterprises. The transaction between related enterprises for which an arm's length price is to be established is referred to as the controlled transaction. The application of transfer pricing methods helps assure that transactions conform to the arm's length standard. It is important to note that although the term "profit margin" is used, companies may also have legitimate reasons to report losses at arm's length. Furthermore, transfer pricing methods are not determinative in and of themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the recognized transfer pricing methods, this does not mean that its pricing should automatically be regarded as not arm's length and there may be no reason to impose adjustments.

Transfer Pricing Methods Overview

The key question is how to apply the arm's length principle in practice to determine the arm's length price of a transaction. Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

All these transfer pricing methods rely directly or indirectly on the comparable profit, price or margin information of similar transactions. This information may be an "internal comparable" based on similar uncontrolled transactions between the entity and a third party or an "external comparable" involving independent enterprises in the same market or industry.

There are five (5) transfer pricing methods as indicated under the TBUCA Regulations. These five transfer pricing methods are also recognized by the OECD and the United Nations in their

respective guides to transfer pricing. The methods can be divided into two major categories: (a) transaction based methods and (b) profit-based methods.

Transaction based methods

Comparable Uncontrolled Price (CUP)

The CUP method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances.

Resale Price Method (RPM)

The resale price method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by the reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

Cost Plus Method

The cost plus method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs incurred by the supplier an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions performed.

Profit-based methods

Two major classes of transactional profit methods are currently in use, as recognised by the USA and the OECD Guidelines. These may be categorised as profit-comparison methods (Transactional Net Margin Method or TNMM / Comparable Profits Method or CPM) and profit-split methods (PSM).

Comparable Profit Methods

This is a type of profit comparison methods (TNMM/CPM). These methods seek to determine the level of profits that would have resulted from controlled transactions by reference to the return realised by the comparable independent enterprise. The TNNM determines the net profit

margin relative to an appropriate base realised from the controlled transactions by reference to the net profit margin relative to the same appropriate base realised from uncontrolled transactions.

Profit-split methods ("PSM")

Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm's length. Arm's length pricing is therefore derived for both parties by working back from profit to price.

The first three methods above i.e. CUP, RPM and Cost Plus are often called "traditional transaction" methods and the last two are called "transactional profit methods" or "profit-based" methods.

Other unspecified methods

Other unspecified methods may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any such method should be applied in accordance with the reliability considerations used to apply the specified methods described above. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. In establishing whether a controlled transaction achieves an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.

Selection of the Transfer Pricing Method under the TBUCA Regulations

Method selection - need for functional analysis.

The selection of a transfer pricing method serves to find the most appropriate method for a particular case. Considerations involved in selecting a method can include the respective strengths and weaknesses of each method; the nature of the controlled transaction; the

availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions. The starting point in selecting a method is an understanding of the controlled transaction (inbound or outbound), in particular based on the functional analysis which is necessary regardless of which transfer pricing method is selected.

Functional analysis is a major part of selecting the transfer pricing method as it achieves the following objectives:

- to identify and understand the intra-group transactions;
- to identify the characteristics that would make a particular transaction or function suitable for use as a comparable;
- to determine any necessary adjustments to the comparables;
- to check the relative reliability of the method selected; and
- over time, to determine if modification of the method is appropriate because the transaction, function, allocation of risks or allocation of assets have been modified.

The major components of a functional analysis are analyses of the functions, assets and risks. A summary approach is provided here for context in the case of selection of appropriate methods.

The functions performed: the functional analysis describes the activities performed such as design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inventory management, outbound logistics, marketing and sales activities, after-sale services, supporting activities, services, advertising, financing and management, etc. The functional analysis must specify which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences
For example the two related companies, A and B, both have inventories but Company A holds inventories for a period of up to 2 years whereas company B only holds inventories for a period of 1 month. The activities that add most value must be identified and should be discussed in more detail.

The risks undertaken: The functional analysis should identify risk undertaken. Examples are: financial risk (currency, interest rate, funding risks etc…), credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk), commodity price risk, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks, market risk (country political risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs and contract enforceability). A risk-bearing party would expect to have higher earnings than a non-risk bearing party, and will incur the expenses and perhaps related loss if and when risk materializes.

The assets used or contributed: the functional analysis must identify and distinguish between tangible and intangible assets. Tangible assets such as property, plant and equipment have to be financed and an investment in such capital assets would usually be expected to earn a long term return based on the use and risk level of the investment. Intangible assets are very important as substantial competitive advantage is often achieved by the use of intangible assets. Some intangibles have legal protection (e.g. patents, trademarks, trade names) but other intangibles with less legal protection may be equally important and valuable (e.g. know-how, trade secrets, marketing intangibles, etc.).

Interplay of above factors: in a multinational group, operations tend to be more integrated across jurisdictional boundaries and the functions, risks and assets are often shared between entities in different jurisdictions. The functional analysis can help identify which functions, risks and assets are attributable to the various related parties. For example, the functional analysis may reveal that one company performs one particular function but the cost thereof is borne by the other party to the transaction. The functional analysis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. There could be another example where one company performs one particular function and bears the cost thereof but the benefit is also accrued to the other party to the transaction. The functional analysis could emphasize that situation and consider which party bears the risk in legal terms and which party bears the risk according to the economic substance of the transaction. The functional analysis typically includes a discussion of the industry in which the tested party operates, the contractual terms of the transaction at issue, the economic

circumstances of the parties and the business strategies they employ. The functional analysis helps to identify the operations that benefit a related party and so require an arm's length return.

Selecting a method after the functional analysis:

Once the functional analysis is performed the application of a transfer pricing method, with the associated evaluation of comparable transactions may be considered. Transfer pricing methods typically use information on comparables, and the lack of such comparables can make a particular method – even one that might seem initially preferred – inapplicable, and a different method more reliable. These comparable transactions are also referred to as uncontrolled transactions because the parties involved in the transactions are independent of each other.

Once a method is chosen and applied, the taxpayers are expected to apply the method in a consistent fashion. Assuming that an appropriate transfer pricing method is being applied, a change in method is typically required only if there are any changes in the facts, functionalities or availability of data.

Section 26.1(c)

Comparable Uncontrolled Price Method ("CUP")

The CUP method determines whether the amount charged as between "associates" or "related parties" is arm's length by looking at the amount in a comparable uncontrolled (i.e. between unrelated companies) situation. If the comparability requirement is met, then the CUP method is usually the most reliable and direct way of arriving at an arm's length price.

For the CUP method to be used, there must be available "comparable transactions". In the situation of a particular set of related companies, the CUP may be used, for example, where an company also sells the same products (as the ones sold to the related company) to other unrelated customers.

When applying the CUP method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences in the transactions being compared that would materially affect the price; or
- Reasonably accurate adjustments can be performed to account for material differences between the controlled and the uncontrolled transaction.

In performing the comparability analysis the controlled transactions and uncontrolled transactions should be compared based on the comparability factors. In determining the degree of comparability between the controlled transactions and uncontrolled transaction , typically the following factors should be taken into account: (i) characteristics of property being transferred or services provided, (ii) contractual terms, (iii) economic circumstances and (iv) business strategies. For the functional analysis it is necessary to analyze the functions performed, the risks assumed and the assets used.

Product comparability should be closely examined in applying the CUP method. A price may be materially influenced by differences between the goods or services transferred in the controlled and uncontrolled transactions. The CUP method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.

Although product comparability is important in applying the CUP method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are also important comparability factors. Where there are differences between controlled and uncontrolled transactions, adjustments should be made to enhance reliability.

Reasonably accurate adjustments may be possible for differences in:

- The type and quality of the products (e.g. unbranded coffee beans from Kenya as compared with unbranded coffee beans from Brazil);
- Delivery terms. E.g. Associated Enterprise 1 in the diagram illustration sells similar bicycles to Associated Enterprise 2

and an Unrelated Party. All relevant information on the controlled and uncontrolled transactions is available to Associated Enterprise 1, and hence it is probable that all material differences between the transactions can be recognized. The uncontrolled price can be adjusted for the difference in delivery terms to eliminate the effect of this difference on the price;

- Volume of sales and related discounts. E.g. Associated Enterprise 1 sells 5000 bicycles to Associated Enterprise 2 for US$90 per bicycle, while it sells 1000 similar bicycles to an unrelated party. The effect of the differences in volume on price should be analyzed, and if the effect is material adjustments should be made based, perhaps, on volume discounts in similar markets)

- Product characteristics. E.g. the uncontrolled transactions to an Unrelated Party involve bicycles on which modifications have been made. However, the bicycles sold in the controlled transactions do not include these modifications. If the product modifications have a material effect on price, then the uncontrolled price should be adjusted to take into account this difference in price);

- Contractual terms. Associated Enterprise 1 sells the bicycles to Associated Enterprise 2 offering a 90 day credit term but the contract terms dictate that all sales to Unrelated Party are Cash On Delivery;

- Risk incurred. E.g. Associated Enterprise 1 is exposed to inventory risk related to sales by Associated Enterprise 2 and the risk that customers of Associated Enterprise 2 will default on their bicycle purchase loans; whereas in the transaction between Associated Enterprise 1 and Unrelated Party, the Unrelated Party is exposed to the inventory risk and the risk of its customers' default. This difference in risk allocation must be analyzed and its effect on price quantified before Associated Party 2's prices and Unrelated Party's prices can be considered comparable;

- Effects of geographical differences. E.g. Associated Enterprise 1 sells bicycles to Associated Enterprise 2 located in South Africa, while an Unrelated Party to which it also

sells the same bicycles is located in Egypt. The only material difference that could be identified between the controlled and uncontrolled transactions concerns the locale. To perform adjustments to account for this difference one might have to consider, for example, differences in inflation rates between South Africa and Egypt, the competitiveness of the bicycle market in the two countries and differences in government regulations if relevant);

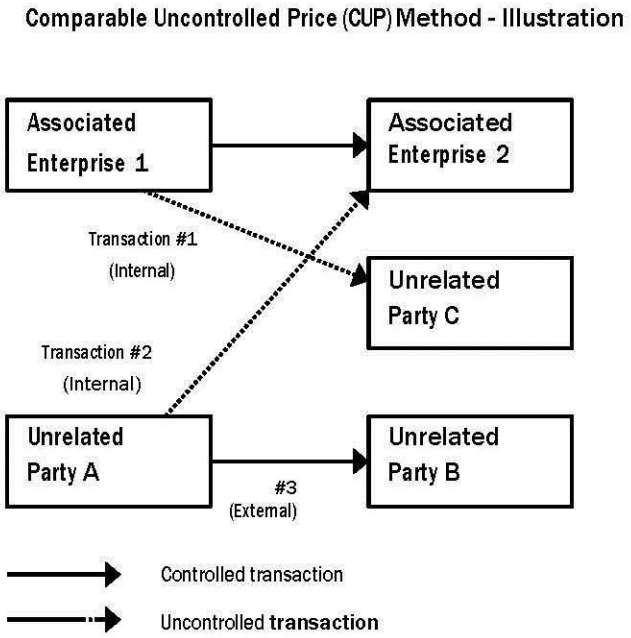
It is assumed that the circumstances relating to the controlled and uncontrolled transactions are similar. The only material difference that could be identified between the transactions is that the price relating to the controlled transaction is a delivered price (i.e. including transportation and insurance), while the uncontrolled transaction # 1 is made ex works, with the buyer taking responsibility from the named place of delivery, which is Associated Enterprise 1's factory. It is possible to perform reasonably accurate adjustments for this difference.
All figures and numeric examples are for practical purposes only. They do not reflect actual cases or actual arm's length figures or margins

Reasonably accurate adjustment may not be possible for:

- Unique and valuable trademarks (e.g. assuming Associated Enterprise 1 in the diagram is engaged in high value branded goods, e.g. watches instead of bicycles, and attaches its valuable trademark to the goods transferred in the controlled transaction, while uncontrolled transaction #1 concerns the transfer of goods that are not branded . The effect of the trademark on the price of a watch may be material. However it will be difficult, if not impossible, to adjust for effect of the trademark on price since the trademark is an intangible asset that is unique. If reasonably accurate adjustments cannot be made to account for a material product difference the CUP method may not be the appropriate method for the transaction); and

- Fundamental differences in the products (e.g. if the products being sold are significantly different from the products sold in the proposed comparable transaction it may not be possible to adjust for the product differences).

Notwithstanding the difficulties often associated with adjustments to address the sources of non- comparability described above, the need to make adjustments should not automatically prevent the use of the CUP method. It is often possible to perform reasonably accurate adjustments. If reasonable adjustments cannot be performed the reliability of the CUP method is decreased. In these circumstances another transfer pricing method may be more appropriate.



Example 1 (Use of the CUP method)

Charlie Sub (CS) manufactures Toy Cars and sells 800,000 items to unrelated customers in Country K for $ 2.20 each. CS will also be selling 800,000 items of Toy Cars to its 75% shareholder company (B), in Hong Kong. With other things being equal, the $ 2.20 per unit price which CS sells to its unrelated Country K customers should be the arm's length transfer price used by CS when selling to B, a related company.

The method as described in Example 1 above is commonly referred to as "Internal CUP".

When there are no "internal comparables" (Internal CUP) as in the example above, one must determine whether External CUP (or "external comparables") is available. In other words, if an company sells all its products to a related company, but not to an unrelated customers, then the

taxpayers and the tax authorities would need to find comparables from outside the related companies in question. The reality of the market place is that no two sales are exactly the same. External CUP is feasible if similar products can be found and which are sold under terms/conditions which are sufficiently similar. If there are differences in product specifications or the conditions of sale, those differences are of a nature that they can be measured and adjusted for. However, if the products or sales conditions differ in material respects so that the differences cannot be quantified and adjusted for in a reasonable manner, then the CUP method should not be used.

Example 2 (Use of the CUP method)

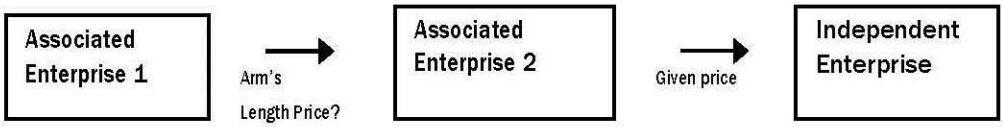
ABC, a Country J manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. ABC's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. Because ABC sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result

26.1(d)

Resale Price Method (RPM)

The second transfer pricing method specified by the TBUCA Regulations is the Resale Price Method (RPM).

Resale Price Method - Illustration (Timor-Leste – Transfer Pricing Regulations)



Given price	=	US$ 100
Resale price margin (25%)	=	US$ 25
Arm's Length Price	=	US$ 75

The resale price method is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The resale price method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis. This is depicted in the diagram above.

All figures used in this and subsequent examples, such as gross margins and net margins, are for illustrative purposes only. They do not reflect actual cases or actual arm's length figure or margins, but are used for ease of calculation

Application of the Resale Price Method. The resale price method analyzes the price of a product that a related sales company (i.e. Associated Enterprise 2 in above diagram) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs and the risks it incurs. The remainder of the product's price is regarded as the arm's length price for the intercompany transactions between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1). As the method is based on arm's length gross profits rather than directly determining arm's length prices (as with the CUP method) the resale price method requires less direct transactional (product) comparability than the CUP method.

Consequently, under the resale price method the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1) can be described in the following formula:

TP = RSP x (1-GPM), where:

• TP = the Transfer Price of a product sold between a sales company and a related company;

• RSP = the Resale Price at which a product is sold by a sales company to unrelated customers; and

• GPM = the Gross Profit Margin that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold.

Example: It is assumed that the resale price in the above diagram is $100. This means that Associated Enterprise 2 resells the bicycle to Independent Enterprise for $100. If we assume that an arm's length gross profit margin that Associated Enterprise 2 should earn is 25%, Associated Enterprise 2 should cover its SG&A expenses and make an appropriate profit with this 25% gross margin. The resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 (i.e. the cost of goods sold of Associated Enterprise 2) is $75 (i.e. $100 x (1-0.25).

Other approaches are possible. For example, if the associated enterprise acts as a sales agent that does not take title to the goods, it is possible to use the commission earned by the sales agent represented as a percentage of the uncontrolled sales price of the goods concerned as the comparable gross profit margin. The resale price margin for a reseller should always be determined by taking into account the functions performed, assets used and risks assumed by the reseller.

Arm's Length Gross Profit Margin:

The financial ratio analyzed under the resale price method is the gross profit margin. Gross profit is defined as net sales minus cost of goods sold. It is easiest to determine where the reseller does not add substantially to the value of the product. The net sales of a sales company are the

sales revenue obtained by selling products to unrelated customers, while the cost of goods sold equals the cost of purchasing the goods sold plus certain additional non-operating costs. Thus, if we are determining the gross margin for products purchased from a related company the cost of goods sold will include the transfer price paid to the related manufacturer.

Accounting consistency is extremely important in applying the resale price method. Gross profit margins will not be comparable if accounting principles and/or practices differ between the controlled transaction and the uncontrolled transaction. For example, the comparable distributors may differ from the related sales company in reporting certain costs (e.g. discounts, transportation costs, insurance and costs of performing the warranty function) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the gross margins. It is thus important that the analysis does not compare "apples with oranges" but rather, "apples with apples". Therefore, appropriate adjustments should be applied to the data used in computing the gross margin to make sure that 'similar' gross margins are compared.

Transactional comparison versus functional comparison:
The arm's length price or margin can result from looking at comparable functionality (distributors of broadly similar types of product) or from making a transactional comparison by looking at each transaction the tested party engages in involving comparable products (i.e. sales of different types of bicycles).

The arm's length (range of) gross profit margin(s) to be earned by the sales company in the controlled transaction can therefore be determined in the following two ways:

- By transactional comparison: For example, one could determine the gross profit margin that Associated Enterprise 2 earns when reselling bicycles purchased from an independent manufacturer in comparable uncontrolled transaction. This uncontrolled transaction may initially have been rejected as an internal comparable for purposes of applying the CUP method because, for example, the transaction involves a different type of bicycle. If the sale of recreational bicycles is at issue, but the unrelated transactions involve rickshaws, taxi bikes this may involve broadly similar products with comparable

accounting measures of Costs of Goods Sold (COGS) making gross margin comparisons sufficiently reliable; and

- By functional comparison: the gross profit margins earned by independent companies in comparable uncontrolled transactions performing functions and incurring risks comparable to the functions performed and risks incurred by Associated Enterprise 2. Functional comparison thus involves a search for comparable distribution companies rather than comparable transactions. This could, for example, include comparable distributors of wheelbarrows and carts.

In practice transactional comparisons are more likely to achieve broad product and accounting consistency than functional comparisons. This means that it is sometimes not necessary to conduct a resale price analysis for each individual product line distributed by a sales company under this method. Instead, the resale price method is used in those situations to determine the gross margin a sales company should earn over its full range of (aggregated) products.

Comparability in applying the resale price method,
An uncontrolled transaction is considered comparable to a controlled transaction if:

- there are no differences between the transactions being compared that materially affect the gross margin (for example, contractual terms, freight terms, etc.); or
- reasonably accurate adjustments can be performed to eliminate the effect of such differences.

As noted above, the resale price method is more typically applied on a functional than on a transactional basis so functional comparability is typically more important than product comparability. Product differences will probably be less critical for the resale price method applied on a functional basis than for the CUP method, because it is less probable that product differences will have a material effect on profit margins than on price. One would expect a similar level of compensation for performing similar functions across different activities.

While product differences may be more acceptable in applying the resale price method as compared to the CUP Method, the property transferred should still be broadly similar in the

controlled and uncontrolled transactions. Broad differences are likely to reflect differences in functions performed, and therefore gross margins earned, at arm's length.

Example: The compensation for a distribution company should be the same whether it sells washing machines or dryers, because the functions performed (including risks assumed and assets used) are similar for the two activities. The price of a washing machine will, of course, differ from the price of a dryer, as the two products are not substitutes for each other. Although product comparability is less important under the resale price method, greater product similarity is likely to provide more reliable transfer pricing results. It is not always necessary to conduct a resale price analysis for each individual product line distributed by the sales company. Instead, the resale price method can be applied more broadly, for example based on the gross margin a sales company should earn over its full range of broadly similar products.

As the gross profit margin remunerates a sales company for performing marketing and selling functions, the resale price method especially depends on comparability regarding functions performed, risks assumed and assets used. The resale price method thus focuses on functional comparability. A similar level of compensation is expected for performing similar functions across different activities. If there are material differences that affect the gross margins earned in the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. In general comparability adjustments should be performed on the gross profit margins of the uncontrolled transactions. The operating expenses in connection with the functions performed and risks incurred should be taken into account in this respect as differences in functions performed are frequently reflected in different operating expenses.

The following issues should be considered in determining whether the functions performed by an uncontrolled entity are comparable to the functions performed by a controlled entity for purposes of applying the resale price method:

- In contrast to the CUP method, the reliability of the resale price method can be influenced by factors that have less effect on the price of a product than on the costs of performing functions. Such differences could affect gross margins even if they do not affect the arm's length prices of products (e.g. the composition of COGS). These factors could include cost structures (e.g. accounting practices), business experience (e.g. start-up phase or mature business) or management efficiency;
- A resale price margin requires particular attention where the reseller adds substantially to the value of the product, for example by assisting considerably in the creation or maintenance of intangible property related to the product (e.g. trademarks or trade names) or where goods are further processed into a more complicated product by the reseller before resale);
- The amount of the resale price margin will be affected by the level of activities performed by the reseller. For example, the distribution services provided by a reseller acting as a sales agent will be less extensive than those provided by a reseller acting as a buy-sell distributor. The buy-sell distributor will obviously obtain a higher compensation than the sales agent;
- If the reseller performs a significant commercial activity in relation to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangibles of the reseller), it may earn a higher gross profit margin;
- The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin;
- The analysis should consider differences in accounting practices that apply to the reseller and to comparable companies in order to make appropriate adjustments to enhance comparability;
- The reliability of the analysis will be affected by differences in the value of the products distributed, for example, as a result of a valuable trademark.

It should be recognized that returns to similar functions may not be the same in different markets. Generally, reliability is enhanced when the reseller and the comparable companies are operating in the same market

The RPM method examines whether the amount charged by an company to a related company is "arm's length" by looking at the "gross profit margin" realized in comparable uncontrolled transactions. The RPM re-computes an arm's length price for the products being sold by subtracting the comparable gross profit margin of comparable unrelated sellers (distributors) from the resale price of the related buyer (i.e. the related company buying from the related seller, and which in turn resells the products).

In applying the RPM, the comparable sale (i.e. data from comparable but unrelated resellers, distributors, etc.) does not have to pertain to identical products. Rather, the RPM aims to provide compensation to the reseller for its resale functions in connection with the product(s) being examined, including an operating profit in return for investment of capital and the assumption of risks. In other words, the arm's length transfer prices are calculated in such a way so as to reflect the similar gross profit ratio as that of an independent, unrelated reseller. The underlying concept is that the unrelated reseller will price its goods to realize a gross profit margin to cover operating expenses, plus a reasonable profit, based on marketplace realities. The gross profit element here equals the value of the resale or distribution functions.

Similar to the CUP method, use of the RPM needs a degree of comparability between the related and unrelated transactions. In contrast to the CUP method, similarity of the physical attributes of the goods/products involved are not important. Rather, the focus on comparability for purposes of the RPM are the resale functions, and the factors affecting the management of and distribution of the products.

The following table lists the typical factors (which are considered as significant in finding comparables of gross profit percentage in RPM:

Factors Relevant to Comparability of Gross Profit Ratios
1. Similarity of functions between resellers
2. Risk distribution as between manufacturer and reseller

3. Terms of sale – contractual terms
4. Management efficiency of reseller
5. Whether intangibles exist for products
6. Level of market – wholesale, retail
7. Sales function, such as advertising, marketing, etc.
8. Cost structures comparison of the resellers

To apply RPM correctly to transactions between related companies, a detailed functional analysis must be performed, so as to take into account factors, such as the ones listed above.

A significant conceptual difference between RPM and CUP is that RPM is concerned with only one side of the transaction. In essence, RPM "fixes" the gross profit of the related company which is the "reseller", according to a "norm" obtained from comparable unrelated resellers. This means that if the "related company reseller" performs above or below this "norm", the effect on profit will be absorbed by the other related company – the manufacturer. Given the situation, the RPM can be used as a tax planning technique – allowing a multinational company to shift profits away from a "related company reseller".

The RPM:

3. starts with the "ending sales price" of the "related company reseller" to unrelated customers.
4. based on comparable unrelated resellers and distributors, computes a "comparable gross profit ratio"
3. using the "comparable gross profit ratio" in 2. above, applies it to the "ending sales price" in 1.above, to determine the "related company reseller" 's "gross profit"
4. subtracting the "gross profit" as determined in 3. above from the "ending sales price" in 1. will yield the "arm's length sale price" from the "related company manufacturer (seller)" to the "related company reseller".

5. as a result, all residual profit is allocated to the "related company manufacturer (seller) due to the "arm's length sale price" result in 4. above.

The RPM can also expressed in formula form as follows:

Arm's Length Price = [Resale Price – (Comparable Gross Profit %* x Resale Price)]

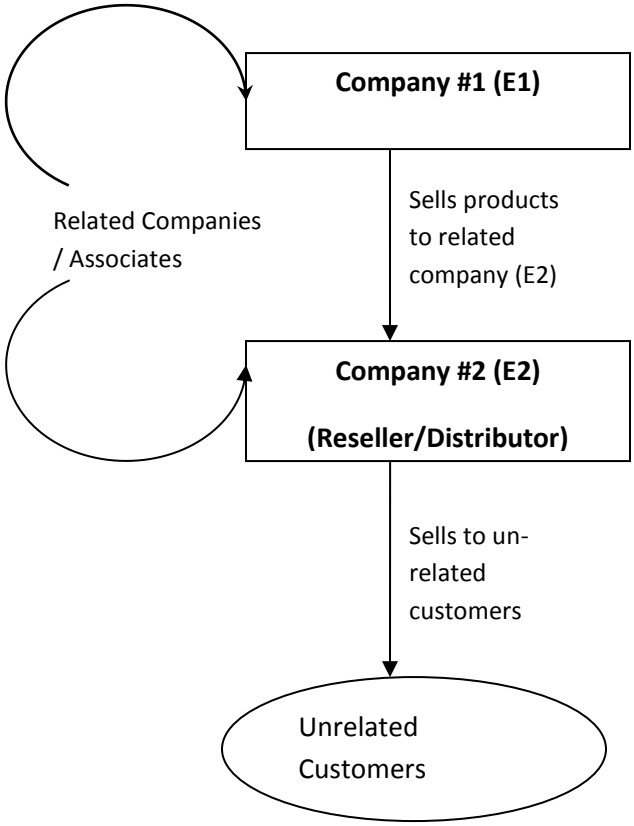
* Comparable Gross Profit % derived from unrelated resellers / distributors after performing detailed functional analyses.

Example 1 (use of the Resale Price Method)

A company sells property to an associate company (member of its controlled group) that resells the property in uncontrolled sales (i.e. sales to unrelated parties). There are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions (i.e. sales to unrelated parties) have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale is a price of $80 ($100 minus (20%×$100)).

The diagram below illustrates how the RPM method works.

Diagram # ___ : Illustration of the Resale Price Method (RPM)



Any remaining profit belongs to E1, the manufacturer

Comparable gross profit margin = 15%

Gross profit = $ 300

Re-sale price = $ 2,000

Arm's length transfer price = $ 1,700

26.1 (e)
Cost Plus Method

The third transfer pricing method specified under the TBUCA Regulations is the cost plus method.

Under the Cost Plus Method, the arm's length transfer price is derived by adding a "gross profit markup" to the selling company's cost of goods sold. The "gross profit markup" is obtained by comparing the related entities' transaction with transactions as between unrelated companies.

The amount of the "gross profit markup" is dependent on a variety of factors, such as: functions performed by the selling company (manufacturer), the sale transaction terms (i.e. contract terms), risks distribution as between the selling company and the buying company. Therefore, the relative size of the "gross profit markup" is usually higher for those seller / manufacturers which engage in the full range of manufacturing function, versus those seller/manufacturers which perform a simpler "contract manufacturing" function.

Similar to the Resale Price Method (RPM), the Cost Plus Method determines an arm's length price by basing it on an assumed gross profit. In contrast to the RPM method however, the Cost Plus Method sets the gross profit of the seller/manufacturer. (In the RPM case, it is the buyer / reseller's profit which is being determined.)

In calculating the transfer price for related companies, the "gross profit markup" is added to the manufacturing costs of the selling company (i.e. the seller / manufacturer), plus other normal costs, such as freight, insurance and customs duties.

An example of the Cost Plus Method computation is as follows:

Cost of sales (production / manufacturing expenses)	=	$ 5,000
Gross Profit Markup (20%)	=	1,000
Other costs (such as transportation, etc.)	=	300

Arm's Length Transfer Price	=	$ 6,300

Similar to the RPM method, the Cost Plus Method looks at only one side of a related company's transaction. Starting with the related selling company (typically the manufacturer)'s production/manufacturing costs, it computes a "gross profit markup" using data from comparable manufacturers / sellers in unrelated situations. That "gross profit markup" (also referred to as "gross profit margin") is applied to the selling company (manufacturer)'s costs. The selling company's profit level is then set. As a result, all remaining profits belong to the buying company (i.e. the related company buying from the selling/manufacturer company).

The practical effect of the Cost Plus Method is that it allocates only the "normal" or "typical" profit to the company which is the manufacturer / seller, so that above normal profits are shifted to the buying company (i.e. the reseller), or if profits are below normal (or for overall loss years), a smaller portion of profits are given to the buying company (the reseller), while the profit to the manufacturer / seller more or less holds steady.

The correct use of the Cost Plus Method is based on the "comparability" of an array of factors between the "related companies" transactions and the "unrelated companies" transactions. For example, if a manufacturing company in the "related" situation perform only the task of assembling the components together, and no more, then in the "unrelated" situation (from which the "gross profit markup" is obtained) the manufacturing company should also only do the assembling function. On the other hand, if the manufacturing company in the "related" situation also performs "designing" and "testing" functions in addition to the "assembling" function, then adjustments should be made to the "gross profit markup" to compensate for the differences in function. In this example, the "gross profit markup" of the "unrelated" situation has to be reduced before it can be used in the "related" situation, to account for the lesser functions being performed by the manufacturing company in the "related" situation.

Factors which should be considered in formulating a transfer price under the Cost Plus Method include the following:

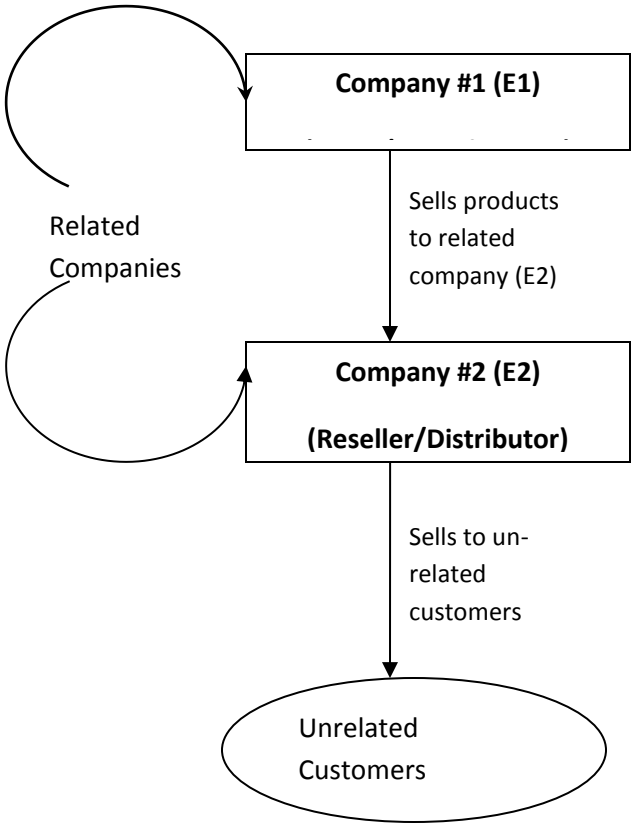
- Degree of complexity in the production and assembly process
- Purchasing, inventory management function
- Testing of products function
- Design of products function
- Sales terms and conditions (including credit terms, risks assumption, warranty provided, etc.)

Example (use of the Cost Plus Method)

R Company, a manufacturer of computer components, sells its products to S, its distributor. T1, T2, and T3 are computer component manufacturers that sell to uncontrolled (unrelated)purchasers.

Relatively complete data is available regarding the functions performed and risks borne by T1, T2, and T3, and the contractual terms in the uncontrolled transactions (i.e. transactions with unrelated parties). In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and R. Because the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions (i.e. transactions with unrelated parties) have been identified, the effect of the differences are definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established .

Diagram # _____ – Illustration of Cost Plus Method



Manufacturing /production cost =RMB 5,000

Gross profit mark up % = 20%

(based on comparable)

Gross profit = RMB 1,000

Arm's length transfer price = RMB 6,300

Any remaining profit belongs to E2, the Reseller/Distributor

Re-sale price = Not relevant in Cost Plus Method

26.1(f)
Comparable Profit Method (CPM)

The CPM concept is to determine whether the amount charged by a company to a related company is at arm's length, based on a "profit level" for comparable situations involving "unrelated companies". The "profit level" which the CPM tries to emulate is the "operating profit" of a company.

As there are at least two (2) companies involved in a transfer pricing for "related companies", a threshold issue is which one of the two companies should be the "tested" party, for the "profit level" to be applied to. In general, the "tested party" is the one with the less complicated functions, and which likely do not own intangible assets.

As in the case of the CUP (Comparable Uncontrolled Price) Method, the proper use of CPM is dependent upon the availability of data from uncontrolled situations (unrelated companies). At present, there is still a general lack of such database availability.

After identifying as to which of the related companies should be the "tested party", the next inquiry is what should be the "profit level indicator (PLI)". This can vary substantially depending on the type of business and function which the company is engaged in. For example, for manufacturing concerns, use of "return on assets" is acknowledged to be an appropriate PLI.

Generally, PLIs should be based on more than one year of operations. This is necessary to avoid extreme fluctuations occurring in a particular year. In practice, at least three (3) years of operations are used.

Correct selection of comparables is a significant part of using the CPM. Detailed functional analysis must be performed on the "tested company" of the related companies, and compare the functions to those from the "unrelated companies" data pool.

26.1(g)

Comparable Profit Split Method

The Profit Split Method takes the "combined operating profit or loss" of the "related companies", and allocates (splits) that profit (or loss) among the two related companies, taking into account the relative contribution made by each company towards generating that profit. The allocation is to be made based on comparable ratios derived from uncontrolled situations (involving unrelated companies) where the parties perform the similar degrees of function as in the case of the "related companies".

There are two major types of Profit Split Method: a. the Comparable Profit Split Method (also referred to as "contribution analysis") , and b. the Residual Profit Split Method, which is discussed in the section below.

Under the Comparable Profit Split Method, the inquiry starts by determining the combined operating profit of unrelated companies, which perform the same relative functions as those in the "related companies" situation being examined. Using the "split ratios" in the unrelated companies' case, the operating profit of the "related companies" is then allocated (or split) with the same ratios. Obviously, in practice it is difficult to obtain the profit split ratio of comparable situations involving unrelated companies.

26.1(b)
Residual Profit Split Method

With the Residual Profit Split Method, a two-step process is employed. First, the operating profits are allocated for the "normal contributions" or functions of the related companies. Second, the remaining (residual) profit is allocated to the companies.

Example (Section 26 – Transfer Pricing Methods with Transfer of Properties - use of Residual Profit Split method)

XYZ is a corporation that develops, manufactures and markets a line of products for use by police in
Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Forcegear). XYZ obtains patent protection for the chemical formula for Forcegear. Since its introduction, Forcegear has captured a substantial share of the market for bulletproof material.

XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Forcegear in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.

XYZ-Asia's research unit alters Forcegear to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2013 taxable year, XYZ-Asia manufactures and sells Forcegear in Asia through its marketing network under one of its brand names.

For the 2013 tax year XYZ has no direct expenses associated with the license of Forcegear to XYZ-Asia and incurs no expenses related to the marketing of Forcegear in Asia. For the 2013 tax year XYZ-Asia's Forcegear sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Forcegear business. The operating assets employed in XYZ-Asia's Forcegear business are $200 million. Given the facts and circumstances, the Country A taxing authority determines that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of Asian companies performing functions similar to those of XYZ-Asia the district director determines that an average market return on XYZ-Asia's operating assets in the Forcegear business is 10 percent, resulting in a market return of $20 million (10% X $200 million) for XYZ-Asia's Forcegear business, and a residual profit of $180 million.

Since the first stage of the residual profit split allocated profits to XYZ-Asia's contributions other than

those attributable to highly valuable intangible property, it is assumed that the residual profit of $180
million is attributable to the valuable intangibles related to Forcegear, i.e. the Asian brand name for Forcegear and the Forcegear formula (including XYZ-Asia's modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2013 on Forcegear related research and development and marketing over the 2013 sales related to such expenditures.

As XYZ's protective product research and development expenses support the worldwide protective
product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business
activities to which they relate. The taxing authority determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the taxing authority capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in the 2013 tax year.

XYZ-Asia's expenditures on Forcegear research and development and marketing support only its sales in
Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development the taxing authority capitalizes and amortizes XYZ-Asia's expenditures and determines that they have a value in 2013 of $0.40 per dollar of XYZ-Asia's Forcegear sales;

Thus, XYZ and XYZ-Asia together contributed $0.60 in capitalized intangible development expenses for
each dollar of XYZ-Asia's protective product sales for 2013, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm's length

royalty for the Forcegear license for the 2013 taxable year is $60 million, i.e. one-third of XYZ-Asia's $180 million in residual Forcegear profit.

Section 27
Transfer Pricing Enforcement and Penalties

Under the TBUCA Regulations, any "**underpayment**" or "**understatement**" of tax due to transfer pricing adjustments will trigger Sections 73 and 74 of the UNTAET Regulations 2000/18.

Sections 73 and 74 of the UNTAET Regulations 2000/18 provide as follows:

Section 73
Failure to deliver tax payment

73.1 Subject to Sections 73.2 and 73.3, where a *person* who is required to deliver tax under the present Regulation fails to deliver all or part of such tax by the due date, that *person* shall be liable to additional tax of 5% of the tax not paid by the due date plus an additional 1% of the tax that remains unpaid on the 15th day of each month following the due date; and:

(a) if failure was due to gross carelessness on the part of the *person*, further additional tax of twenty-five percent (25%) of the tax that remains unpaid; or
(b) if failure was due to a deliberate attempt to avoid payment of tax, further additional tax of one hundred percent (100%) of the tax that remains unpaid.

73.2 Where the due date that any tax required to be delivered by under the present Regulation does not fall on a business day, the due date shall be the next business day following the due date.

73.3 In order for any tax that is required to be delivered under the present Regulation to the Central Payments Office or its nominated agent to be treated as having been delivered by the due date, the Central Payments Office or its nominated agent must have received that tax by that due date.

Section 74
Understatement of tax

Where a *person* who is required to complete a *tax form* under the present Regulation has understated the amount of tax required to be shown on that *tax form*, that *person* shall be liable to additional tax of fifteen percent (15%) of the understatement and:

(a) if the understatement was due to gross carelessness on the part of the *person*, further additional tax of twenty-five percent (25%) of the tax understated; or
(b) if the understatement was due to a deliberate attempt to avoid payment of tax, further additional tax of one hundred percent (100%) of the tax understated.

Note that under the UNTAET regulations Sections 73 and 74, there are separate penalties for (a) failure to pay tax and (b) the understating of the tax liability.

However, in order for the civil penalties under TBUCA Regulations Section 27 to apply, the needs to at least a ten (10) percent adjustment of the gross receipts of the taxpayer.

Example (Section 27 – Transfer Pricing Enforcement and Penalties)

Company T was subject to a tax audit for the tax year 2013, with the audit examination on the transfer pricing arrangements of Company T with its affiliated associated enterprises. Company T's gross receipts as reported on its original tax return, before the audit, was US$10,000,000. The tax as reported and paid on the original tax return was US$300,000. The 2013 year tax return was filed, and the tax paid, on March 31 2014. After the audit, the Commissioner of Taxation issued a tax assessment against Company T, adjusting the gross receipts for the 2013 year to US$12,000,000 , increasing by $2,000,000 from the original reported gross receipts of $10,000,000. The additional tax due for 2013, as a result of the tax assessment, was US$600,000. The audit was concluded and the tax assessment was issued on Jan 31 2015.

The adjustment to Company T's gross receipts exceeded 10% of the original gross receipts amount (10% x $10,000,000 = US$1,000,000), as the adjustment was 20% of the gross receipts amount (US$2,000,000 / $10,000,000 = 20%), then the civil penalties of TBUCA Regulations Section 27 will now apply. This inaccuracy of Company T's 2013 year tax return, because the net adjustment is 10 percent or more, is referred to as a "substantial valuation misstatement".

The civil penalties applicable are as follows:

Assuming that Company T paid the additional tax due based on the audit tax assessment issued on Jan 31 2015 on the same date (i.e. payment made on Jan 31 2015), then the UNTAET Section 73 penalty is: "additional tax of 5% of the tax not paid by the due date plus an additional 1% of the tax that remains unpaid on the 15th day of each month following the due date", calculated as follows:

5% x $600,000 = **$30,000**

1% x 10 months = 10% x $600,000 = **$60,000** (since after Mar 31 2014, the unpaid tax of $600,000 was not paid for 10 months on the 15th of each month beginning Apr 2014 to Jan 2015)

Since the Commissioner has determined that Company T's failure was due to gross carelessness, but not due to a deliberate attempt to avoid payment of tax, additional penalty of 25% x $600,000 = **$150,000**, will apply.

The total UNTAET Section 73 penalties is therefore: $240,000 ($30,000 + $60,000 + $150,000 = $240,000).

Then, under UNTAET Section 74, the following penalties will apply:

15% x $600,000 = **$90,000**, being 15% of the understatement of tax, as per Section 74.

25% x $600,000 = **$150,000**, being the understatement due to gross carelessness of the taxpayer, while the 100% penalty of Section 74(b) will not apply since the taxpayer was not determined to have deliberately attempted to avoid payment of tax.

Therefore, the total UNTAET Section 74 penalties are: $240,000 ($90,000 + $150,000 = $240,000).

As a result, the UNTAET Section 73 and Section 74 penalties combined which will apply under the TBUCA Regulations, as a result of the additional tax assessment due to the transfer pricing adjustments would be $480,000 (Section 73 penalty of $240,000 + Section 74 penalty of $240,000 = $480,000).

Section 28
Documentation Requirements

TBUCA Regulations Section 28 sets out the documentation requirements for transfer pricing purposes under Timor-Leste tax law.

Adequate transfer pricing documentation will make it easier for tax authorities to review a taxpayer's transfer pricing analysis and thereby contribute to avoiding a dispute or to a timely resolution of any transfer pricing disputes that may arise. Adequate documentation is characterized by (i) the sufficiency of the details demonstrating the taxpayers' compliance with the arm's length principle, as well as (ii) the timely manner in which such details are prepared and submitted to tax authorities upon their request. Therefore, it is in the interest of both the taxpayer(s) and the Tax Administration of Timor-Leste that the transfer pricing documentation in support of transfer pricing arrangements be well prepared, and that the rules for such documentation under the TBUCA Regulations be relevant and clear.

Under these guidelines for the TBUCA Regulations, first the documentation requirements of the TBUCA Regulations will be summarized, and then second, a discussion of the principles and objectives of transfer pricing documentation will be presented, in the context of Timor-Leste tax law.

The TBUCA Regulations documentation requirements are as follows:

- A taxpayer with an aggregate related party transaction or transactions in the sum of Five Hundred Thousand US Dollars (US$500,000) or more in a tax year is required to report and disclose such transaction(s) in the income tax return filed for the tax year
- Taxpayers are to keep and maintain accessible books and records containing all relevant information about such transaction(s) for a period of seven (7) years, commencing from the date the information or tax return containing the disclosures is filed
- Taxpayers are to compile transfer pricing documentation supporting the pricing of the related party transaction(s) in the sum of US$500,000 or more.

Under TBUCA Regulation Section 28(a), the transfer pricing documentation requirement is deemed met if the taxpayer maintains:

- sufficient documentation to establish that the taxpayer can reasonably conclude that, given the available data and the applicable pricing methods, the transfer pricing method as selected by the taxpayer in its transfer pricing methodology provided the most reliable measure of an arm's length result under the principles of the Best Method Rule as described the present TBUCA Regulations, and

- provides that documentation to the Tax Administration within thirty (30) days of a request for such documentation by the Tax Administration, in connection with an examination of the taxable year to which the documentation relates

- The documentation must be in existence when the return is filed. The Commissioner may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply and the taxpayer promptly remedies the failure when it becomes known.

Then, TBUCA Regulations provides that, for those taxpayer(s) which are required to prepare the transfer pricing documentation of the TBUCA Regulations, because they fall within the threshold as specified in the TBUCA Regulations, the documentation must be in existence when the return is filed. In other words, the documentation requirement is "contemporaneous" under the TBUCA Regulations. An exception for the contemporaneous requirement is made for items (viii) and (ix) of the **principal documents** listed below.

Under the TBUCA Regulations, for purposes of the contemporaneous documentation of the TBUCA transfer pricing rules, the **principal documents** to be maintained by the taxpayer include the following:

i. an overview of taxpayer's business, including an analysis of the economic and legal factors affecting pricing;

ii. a description of taxpayer's organizational structure covering all related parties engaged in transactions potentially relevant

iii. a description of the method selected and an explanation why the method was selected;

iv. a narrative of the alternative methods that were considered and the reasons for rejecting those alternatives methods;

v. a description of controlled transactions and any internal data used to analyze those transactions;

vi. a description of the comparables that were used, how comparability was evaluated, and what adjustments (if any) were made;

vii. an explanation of the economic/functional analysis and projections relied upon in developing the method;

viii. a description or summary of any relevant data that the taxpayer obtains after the end of the year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

ix. a general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

The TBUCA Regulations also provide that transfer pricing documentation prepared for a foreign tax jurisdiction will not be considered acceptable for Timor-Leste taxation purposes.

Transfer Pricing Documentation – Principles and Objectives – In the Context of Timor-Leste Tax Laws

The OECD's guidance on documentation is well summarized in the following paragraphs of the

2010 version of the OECD Transfer Pricing Guidelines[23]:

"Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.

Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of exchange of information articles in certain cases so that less need be asked of the taxpayer in the context of an examination …"

[23] 2010 OECD Transfer Pricing Guidelines, Section 5.28 and 5.29

It is recognized that most non-OECD countries, such as Timor-Leste, do not have the extensive treaty networks of OECD countries and there will often have to be more reliance upon taxpayer provided information for this reason.

Under the OECD Guidelines, the following types of information among other things should be made available through documentation, although it is neither a minimum compliance list nor an exclusive list of information:

- Information about the associated enterprises involved in the controlled transactions and independent enterprises engaged in similar transactions;
- Information regarding the nature and terms of the controlled transactions, economic conditions and property involved in such transactions, product or service flows and changes in trading conditions or renegotiations of existing arrangements
- Description of the circumstances of any known transactions between the taxpayer and an unrelated party that are similar to the transaction with the foreign associated enterprise, and therefore might be an arm's length comparison;
- Outline of the business structure of the organization, including the associated enterprises and ownership linkages within the multinational enterprise group
- Information about the amount of sales and operating results of the associated enterprises from the last few years preceding the transaction; and
- Information on pricing, including business strategies and special circumstances that may be relevant, such as a "set-off" arrangement with the buyer providing the seller some services as part of the transaction.

Such information will help evaluate the functions performed by the associated enterprises, the assets used in doing this, and the risks assumed by the parties to the transaction, all of which will be important to a functional analysis, which as already mentioned in these guidelines to the TBUCA Regulations section, is a pre-condition to the proper selection of transfer pricing methodology.

In 2003, the Pacific Association of Tax Administrators ("PATA"), which is comprised of tax administrations from Australia, Canada, Japan and the U.S., announced its "Transfer Pricing Documentation Package" (the "Package"). At present, Timor-Leste is not a member of PATA, and accordingly, the PATA Package has no relevance to the documentation rules for purposes of the TBUCA Regulations.

In applying and interpreting the TBUCA Regulations as to what information to be included in the TP (transfer pricing) documentation, the following general principles should be borne in mind:

- In preparing TP documentation, taxpayers must decide the type and scope of documentation and information that should be provided to meet the documentation requirement and avoid any tax adjustments and penalties, while at the same time minimizing added burdens and potential tax exposure in the event of a tax audit

- The main objective of preparing and maintaining documentation is to place the taxpayer in a position where it can readily demonstrate that it has exerted reasonable efforts to ensure that its transfer prices are consistent with the arm's length principle.
- While the TBUCA Regulations expressly provides a list of the principal documents which should be maintained by the taxpayer, it should not be necessarily be considered as an exclusive listing, as it is not possible to specify a comprehensive list of documentation requirements that would meet the needs of all taxpayers and situations, because the documentation required depends on the specific facts and circumstances of each case.

- First of all, information as to the related parties that are involved in the controlled transactions at issue needs to be documented. Such information includes i) an outline of business with transaction parties, ii) the structure of the organization, iii) ownership linkage within the multinational group, iv) the amount of sales and operation outcome from the last few years preceding the transaction; v) the level of the taxpayer's transactions with foreign related parties, for example the amount of inventory sales, value of services rendered, rent for tangible assets, the use and transfer of intangible property, and interest on loans, etc.. Information about functions performed, assets employed and risks assumed would be important items for TP documentation.

- The current business environment and forecasted changes or commercial and industry conditions affecting the taxpayer, such as market scale, competitive conditions, regulatory framework, technological progress, foreign exchange market, also may need to be documented.

- An explanation of the selection, application, and consistency with the arm's length principle of the transfer pricing method used for the establishment of the transfer pricing is also needed. Information on factors influencing the setting of prices or the

establishment of any pricing policies for the taxpayer and the whole MNE group would be also useful.

- If the documentation is designed to allow the evaluation of comparables used in a transfer pricing study, it would not be sufficient merely to provide a list of "comparables." In cases where internal or third-party comparables are used by a taxpayer to support its transfer pricing policy, supporting documentation should be provided explaining the process followed to arrive at a particular list of comparables and the arm's length range of those comparables.

- Where a transfer pricing study relies on comparable information which has been obtained following such a process, it would be reasonable to expect each of the steps to be documented in order to make it possible for the tax administration conducting an audit to assess the quality of the analysis.
    - For example, if a taxpayer uses multiple-year data on the ground that its transactions are affected by business cycles, it would be reasonable for the taxpayer to provide some documentation explaining why a business cycle is a factor to be considered, the type (e.g., business cycle, product cycle) and duration of the cycle and placement of the controlled enterprise in the cycle. Based on this analysis, the qualitative and quantitative criteria used to select or reject comparables should be carefully documented

- Where a taxpayer concludes that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amount at issue, reasons for such conclusion should be duly explained together with supporting documentation.

- Special circumstances would include details concerning any intentional set-off transactions that have an effect on determining the arm's length price. In such a case, documentation may be necessary to help describe the relevant facts, the qualitative connection between the transactions, and the quantification of the set-off arrangement. In this situation, contemporaneous documentation helps minimize the use of hindsight, and the possible suggestion of manipulation based on that hindsight.

- TP documentation for intra-group services is important to satisfy as to the legitimacy of intra-group service charges, including management fees. When TP documentation is prepared for intra-group services, it should be focused on whether intra- group services have in fact been provided and what the intra-group charge should be for such services for tax purposes. Once the relevant intra-group services have been identified, the

documentation of such intra-group services performed by the service provider and the benefits received by the service recipient should be thoroughly prepared.

- A cost contribution arrangement (CCA)[24] is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. Documentation is crucial for the proper operation and tax treatment of a CCA because the form and value of each participant's contribution cannot be properly obtained without proper documentation. Prudent business management principles would lead the participants to a CCA to prepare or obtain materials regarding the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle.

    - Over the duration of the CCA's term, the following information could be particularly useful:
        - Terms, participants, subject activity and conditions of initial arrangements and any change to the arrangement;
        - The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
        - The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined;
        - Any provisions for balancing payments or for adjusting the terms of the arrangements to reflect changes in economic circumstances;
        - A comparison between projections used to determine expected benefits from CCA activity with the actual results; and
        - The annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's terms, and a detailed description of how the value of contributions is determined and how accounting principles are applied consistently to all participants.

[24] In some tax jurisdictions, this is referred to as "cost sharing arrangement"

Section 30
Tax Audit

Section 30 of the TBUCA Regulations provides that the Tax Commissioner shall have the authority to conduct periodic tax audits to test tax compliance. The following sections also deal with the tax audit process:

Section 31 (Tax Audit Methods)

Section 32 (Office Control)

Section 32A (Field Controls)

Section 34 (Participation of a Taxpayer in Office Control Procedure)

Section 35 (Change of Tax Liability upon Findings of Desk / Office Controls)

Section 36 (Field Audit Controls)

Section 37 (Field control Procedure)

Section 38 (Time of Field Control)

Section 39 (Report)

Section 39A (Tax Audit Conferences)

It should be noted that there are several provisions of the Indonesian Law on Income Tax and the General Tax Regime and Procedures[25] speaking to the authority of the Commissioner to conduct tax audit. The UNTAET Regulation 2000/18[26] and the Ministerial Diploma 3/2009[27], issued pursuant to Decree-Law 13/2009 cumulatively provide additional legal framework for a tax audit of the taxpayers subject to the TBUCA and the TBUCA Regulations.

[25] See. Section 29(1) the Law on the General Tax Regime and Procedures.
[26] See- UNTAET Reg. 2000/18, Sections 51, 62-64.
[27] See-Articles 17(a), (b), (d), (e), 18(1), 2(e),(f), (g), (h) and (j).

The outcome of an effective audit process is two-fold:

(i) encourage future compliance and

(ii) increased current tax revenues (where cases are successfully audited).

The better the "quality" of the cases referred for audit, the higher the probability of successful audits and vice versa. It is therefore just as important to dedicate adequate time and resources to risk assessment as it is to dedicate the appropriate time and resources to the audit of a case. Risk assessment should be carried out at various stages of the audit subsequent to the initial risk assessment, similar to a cost/benefit analysis, to ensure the most efficient and effective use of time and resources. This should be built into the auditing process and incorporated as part of the audit program. A risk identification and assessment process followed by engagement with the taxpayer can at times be a worthwhile approach to adopt.
This allows for better understanding of the risks identified and gives taxpayers the opportunity to explain the commercial context of the transactions/risks identified. Such an approach is again designed to ensure that the risks have been profiled in the most robust manner before resources are committed to carrying out an in-depth audit.

It is also useful to organize an audit manual, which will provide the policies and standardized procedures in conducting audits. Then, for each taxpayer selected for audit, an audit program should be developed for the specific audit. The audit program should include as many details as possible, such as: type and quantity of information to be requested, location(s) of audit, personnel of the taxpayer to be present at various stages of the audit, areas of audit focus, expected timing of the audit.

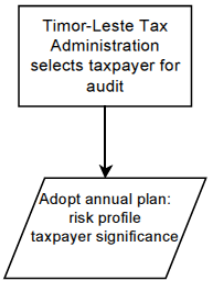
In making selections of audit targets amongst the Contractor, the Timor-Leste Tax Administration pays particular attention to those which may have a higher risk of **transfer pricing audit issues**:

- Consistent and continued losses, or "diminished" taxable income;

- Transactions with related parties in countries with lower effective/marginal tax rates, especially secretive jurisdictions;
- Local low profit or loss making companies with material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralized supply chain companies in favorable tax jurisdictions i.e. centralized sourcing or marketing companies located in jurisdictions with low or no tax regimes and which are not located in the same country/region as the group's main customers and/or suppliers.
- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing rules – the corporate group may be more likely to set transfer prices in favour of the more aggressive jurisdiction at the cost of the less aggressive jurisdiction, due to the higher likelihood of intense scrutiny in the first jurisdiction.
- The same applies in the case of material commercial relationships with companies located in the "home" jurisdiction of the MNE or the location where the holding company is listed.
- Similar considerations apply where there are material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align to the arm's length principle.

Accordingly, in the selection of taxpayer audit targets, the following factors are normally considered by the Tax Administration, in accordance with the TBUCA Regulations and other applicable laws:

- Tax risk profile of taxpayer
- Past conduct of the taxpayer
- Significance of the taxpayer-relative to the Timor-Leste revenue
- Evaluate effect of tax audit and control on efficiency of tax collection



Authority of Timor-Leste Tax Administration to access Taxpayer Information

According to TBUCA Regulations Section 30A, any authorized officer or employee of the Tax Administration, designated and acting via the authority of the Commissioner:

- may examine the relevant books, papers, records or other data
- take relevant testimony of the person concerned, under oath
- summon the person liable for tax or required to perform the act, or any officer or employee of such person or any person having possession, custody, or care of books of accounts containing entries relating to the business of taxpayer to appear before one or more officers or employees of the Tax Administration to produce such books, papers, records, or other data to give relevant testimony, under oath
- take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry

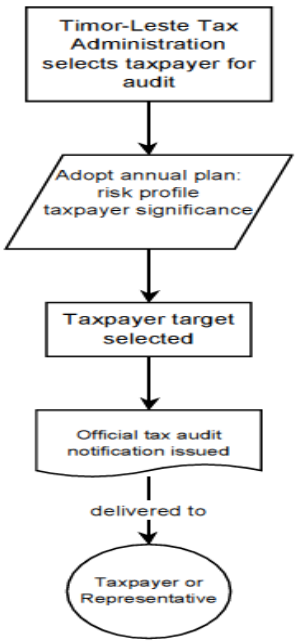
This summons power may be used in an investigation of either civil or criminal tax related liability. To give force and meaning to the general authority to examine, the Timor-Leste Tax Administration has the statutory power to compel a taxpayer or any other person to produce records and testify under oath.

The Commissioner may designate one or more officer or employee and is authorize such individual to take testimony under oath of the person summoned and to receive and examine books, papers, records, or other data produced in compliance with the summons.

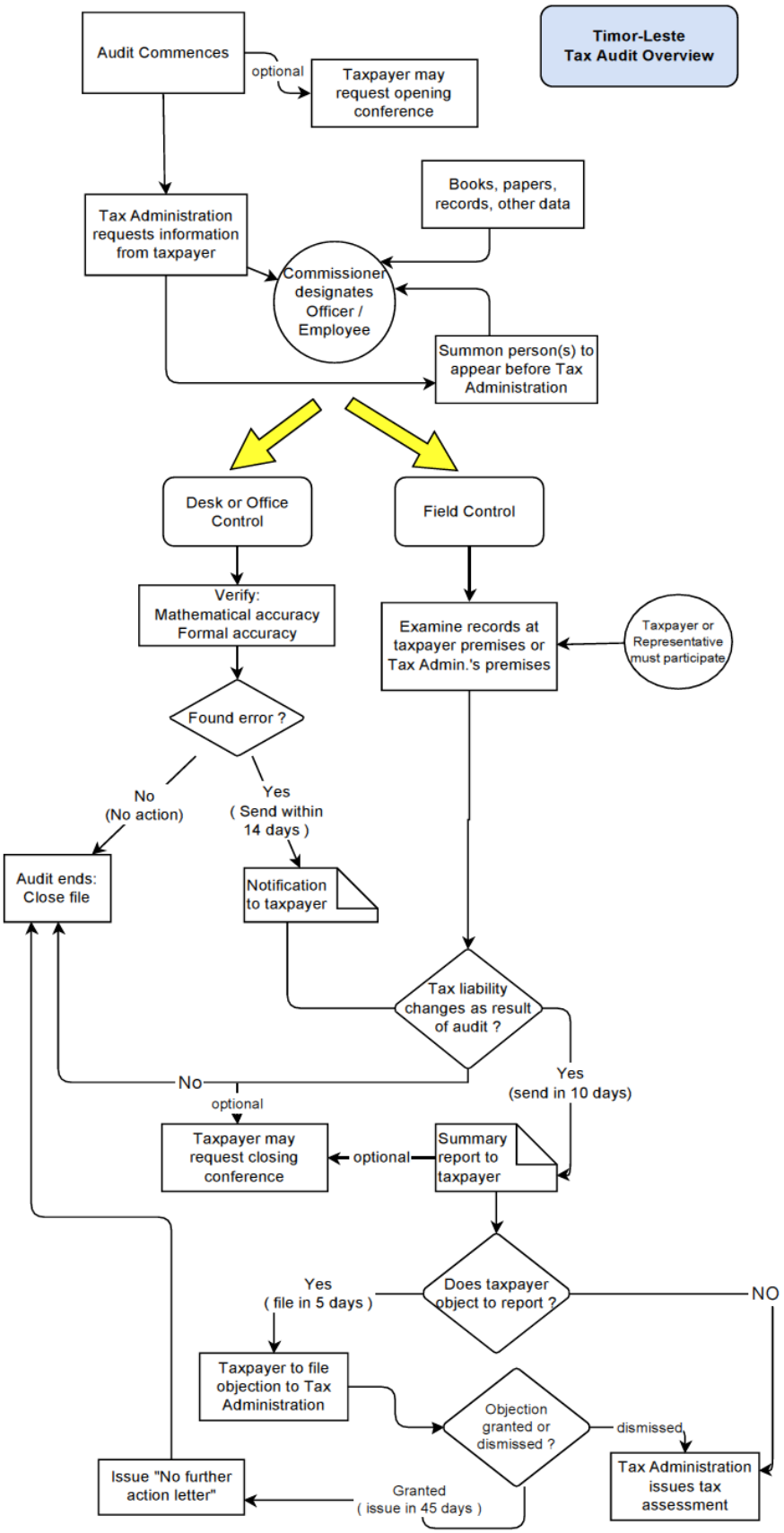
Under TBUCA Section 30, the sequence of a typical audit is as follows:

- a tax audit is commenced with an official tax audit notification issued by the Tax Administration and delivered to a taxpayer, or the taxpayer's representatives, as the case may be

- a taxpayer under tax audit shall, upon a written request by the Tax Administration:
  - show and or submit books and records, or copies thereof, documents and or information specifically requested by the Tax Administration and forming the basis of the book and records, documents pertaining to income received, expenditures incurred, business activities, independent work of the taxpayer or the independent work performed for the taxpayer and connected with a petroleum project, directly or indirectly
  - grant access to enter such places or offices, factory, installations, platforms, Contract Area as is deemed necessary and material to carrying out the audit



Timor-Leste taxpayer audit target selection


Timor-Leste
Tax Audit Overview
Audit Commences
optional
Taxpayer may request opening conference
Books, papers, records, other data
Tax Administration requests information from taxpayer
Commissioner designates Officer / Employee
Summon person(s) to appear before Tax Administration
Desk or Office Control
Field Control
Verify: Mathematical accuracy Formal accuracy
Examine records at taxpayer premises or Tax Admin.'s premises
Taxpayer or Representative must participate
Found error ?
No (No action)
Yes (Send within 14 days)
Audit ends: Close file
Notification to taxpayer
Tax liability changes as result of audit ?
No
optional
Yes (send in 10 days)
Taxpayer may request closing conference
optional
Summary report to taxpayer
Does taxpayer object to report ?
Yes (file in 5 days)
NO
Taxpayer to file objection to Tax Administration
Objection granted or dismissed ?
dismissed
Tax Administration issues tax assessment
Issue "No further action letter"
Granted (issue in 45 days)

Tax Audit in the format of Office Control

If the tax audit is conducted in the format of "Office Control", then the Tax Administration conducts the following procedures:

- verifies the accuracy, completeness, truthfulness and legal base of the data shown in tax or information returns of whatever description,
- reviews the tax balances, accounting statements and other statements or positions of the taxpayer, comparing the said data to data from tax accounting records and other official records kept by, or at the disposal of, the Tax Administration

Office controls are conducted in the premises of the Tax Administration by tax auditors or inspectors and or lawyers.

Tax Audit in the format of Field Control

If the tax audit is to be conducted in the format of "Field control", then the Tax Administration conducts the following procedures:

- examination of the taxpayer's books and records either at the taxpayer's premises or at the premises of the Tax Administration
- An examiner will check the entire return filed by the taxpayer and will examine the books, papers, records and memoranda dealing with matters required to be included in the return
- If the return presents an engineering or appraisal problem (e.g. depreciation or depletion deductions. Gains or losses upon the sale or exchange of property, or losses on account of abandonment, exhaustion, or obsolescence), it may be investigated by an engineer agent who makes a separate report.

In the case where the tax audit is to be conducted in the format of a "field control", then the taxpayer has the following responsibilities and rights:

- if the field control is conducted in a premises occupied, owned, leased on controlled by the taxpayer, to designate an appropriate working area at the disposal of the tax auditors, inspectors and or their representatives

- during the field audit and during the business hours of the taxpayer, the auditors, inspectors and representatives of the Tax Administration shall have the right to enter and remain in the places designated by taxpayer for use of the tax auditors, where the taxpayer may be conducting its business

- the taxpayer or a representative with a valid power of attorney may be during the inspection of the books and records of the taxpayer by the auditors
- if the taxpayer or representative are not present and the audit progress is consequently prevented or delayed, a notation must be made in the audit record

- if the field control is not conducted in the business premises of the taxpayer, the auditors or their representatives may inspect the taxpayer's business premises and enter the report of the inspection in the audit records. In such a case, the taxpayer shall be required to participate in the fact finding process relevant to taxation in such manner so as to give information and statements at the written request of the Tax Administration

- the taxpayer is required to enable the tax auditors and their representatives to obtain copies of relevant documents and or samples of goods

- if the taxpayer is unable to attend, the taxpayer must delegate a person to act as his agent or representative to attend the audit

- the auditors and their representatives may request in writing the data or other documentation from employees of the taxpayer or other persons controlling such data or documentation
- the taxpayer's employees and persons with control of the relevant are obligated to make the information or documentation at their disposal available to the Tax Administration

- if a field control tax audit is conducted at the taxpayer's premises, it shall be conducted only during the taxpayer's working hours and exceptionally after working hours as well, if the purpose of the field control requires this and if the taxpayer consents

Stay of Statute of Limitation when Tax Audit is Pending (TBUCA Regulations Section 39B)

Under the TBUCA Regulations, once a tax audit commences against a taxpayer (the date on which the audit notice is served on the taxpayer is considered the audit commencement date), then the statute of limitation is stayed.

Taxpayer's Right to Appeal Upon Tax Assessment

Under the TBUCA Regulations, the taxpayer has a right to appeal against a tax assessment.

The procedures which a taxpayer wishes to appeal are specified in TBUCA Regulations, Section 40, which provide in summary form as follows:

- the notice of appeal against an assessment, reassessment or any other decision of the Commissioner shall be submitted to the Appeals Office within sixty (60) days from the day on which the assessment was delivered to the appellant
- the appeal fees (as set by the Commissioner) must accompany the notice of appeal
- three (3) copies of the notice of appeal and any accompanying documents have to be submitted
- the notice of appeal must be signed by the appellant (i.e. taxpayer) or a representative of the appellant
- Copy of the tax assessment as issued by the Commissioner has to be attached to the notice of appeal

The notice of appeal which the taxpayer submits must contain the following information:

i. the amount as set by the respondent (i.e. the Commissioner) as chargeable income and amount of tax according to the tax assessment (i.e. the tax amount in the tax assessment as issued)

ii. the amounts which, according to the appellant (i.e. the taxpayer)'s contention , should be the correct amount of chargeable income and tax;

iii. a narrative of the factual and legal reasoning forming the basis of the Appellant's disagreement with the disputed assessment

iv. the relief sought by the Appellant (i.e. the taxpayer)

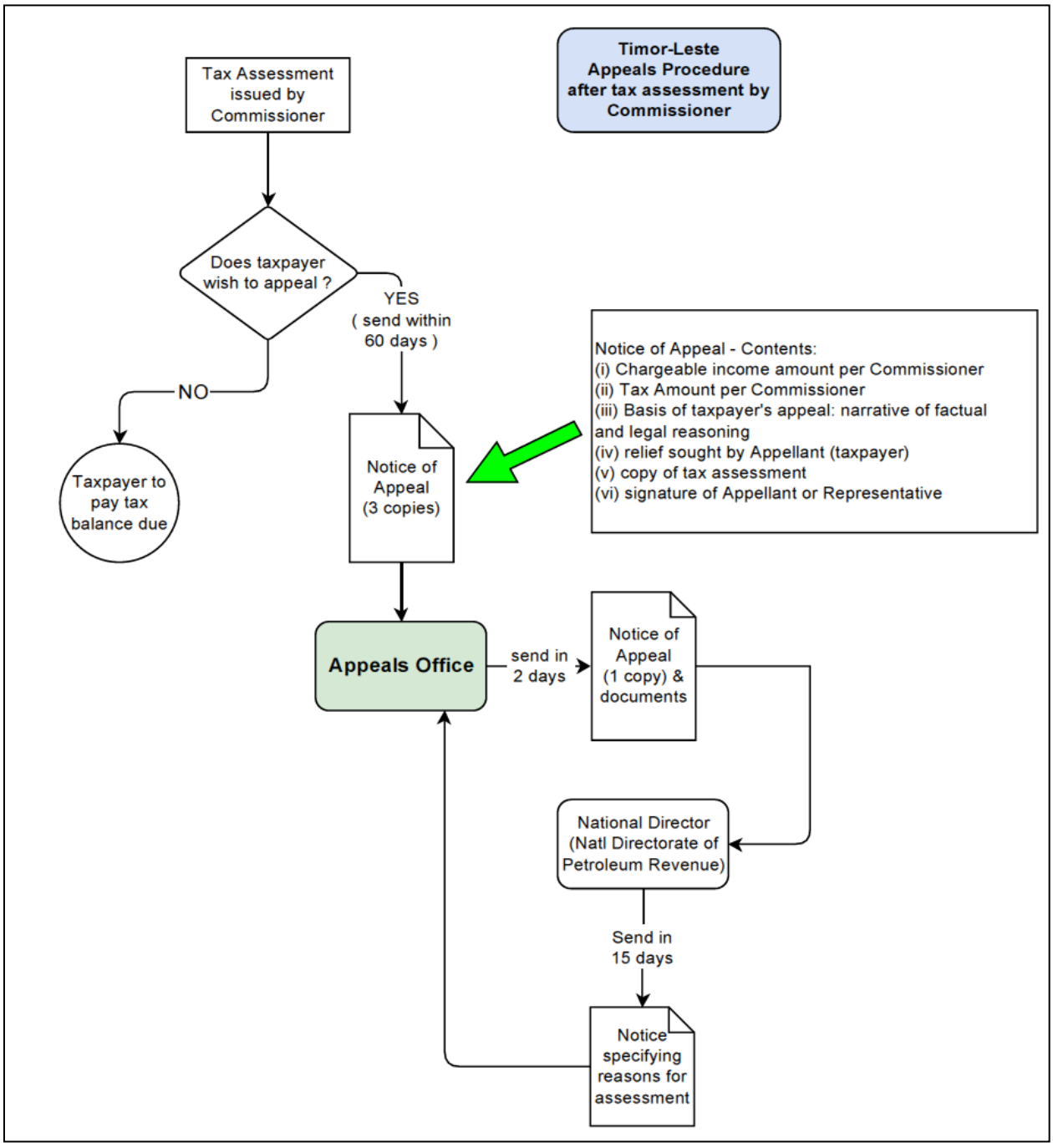
Then, on the part of the Tax Administration, the following procedures are required to be followed:

- the Appeals Office has to provide a copy of the notice of appeal and any documents received from the Appellant (i.e. the taxpayer) to the National Director of the National Directorate of Petroleum Revenue within two (2) business days from the date of receipt from the Appellant

- the National Director of the National Directorate of Petroleum Revenue has to submit to the Appeals Office within fifteen (15) days after receiving the notice of appeal: a written notice specifying the reasons for the assessment. For this purpose, a copy of the pre-assessment letter (if any) issued to the appellant (i.e. taxpayer) and any subsequent correspondences between the National Director and or the Commissioner and the Appellant may be substituted as the written notice required

- Where new issues are raised by the appellant other than those covered in the pre-assessment letter (if any) and other related correspondences, the Appeal office may require the National Director of NDPRM to submit a written brief in response to the appeal.

Diagram of the appeals procedure



Section 33A
Amendment of Tax Returns

After a taxpayer has filed a tax return for a particular taxable period, and provided that a tax audit has not been initiated by the Tax Commissioner against the taxpayer for the tax return for that particular year, the taxpayer may submit an amended return to correct the original tax return.

However, the taxpayer must submit the amended tax return within twenty four (24) months of the date on which the original tax return was due, or, if there was a tax liability, within twenty four (24) months of the date the original tax liability was due.

If a taxpayer initiates an amendment of a tax return resulting in an increase in the tax liability amount from a prior period, the taxpayer shall be subject to the civil penalty provisions of Sections 73 and 74 of the UNTAET Regulation 2000/18.

Example (Section 33A – Amendment of Tax Returns)

Company X filed its corporation income tax return for the year 2012 on January 15, 2013. There was no balance due on the tax return, as Company X had overpaid its 2012 tax by the installment payments it had made during 2012. Then, in February 2015, Company discovered it made an error, and had overstated its income for the year 2012, and as a result overstated its 2012 tax on the original tax return as filed. Since the original due date of Company X's 2012 tax return was March 31 2013, the twenty four (24) months' time period to determine the deadline for amending the 2012 return began to run on March 31 2013, and not on January 15 2013. Therefore, under the Regulations, Company X has until March 31 2015 to file an amended tax return for the tax year 2012, to correct its original 2012 tax return as filed.

The Additional Petroleum Tax Regime

The Additional Petroleum Tax (APT) regime is governed primarily by Sections 11-18 of the TBUCA and 17-24 of the TBUCA Regulations. The APT is separate and distinct from the Corporate Income Tax (CIT) and it is an additional tax imposed only on Contractors after reaching certain milestones (i.e. recovery of cost). The APT is payable only where a Contractor has a positive amount of accumulated net receipts arising from Petroleum Operations for a tax year. The APT payable for a particular year is deductible in the calculation of the taxable income of the Contractor in the year in which the Contractor is subject to APT.

The APT is calculated in accordance with this formula:

A x 22.5% / (1-r)
where:
A: is the "accumulated net revenue" of the Contractor for the Petroleum Operations for the year; and
r: is the rate of corporate Income Tax (30% as stipulated in Section 3.3 of the TBUCA).

The accumulated net revenue (ANR) of a Contractor for Petroleum Operations as prescribed under Section 84.1 of the TDA for a tax year is calculated according to the following formula:

((A x 116.5%) – (I x (1-r))) + B

where:

A: is the Contractor's accumulated net revenue for the Petroleum Operations at the end of the previous tax year (entered as a negative to denote a loss), and is deemed to be nil if APT was payable in the previous year of tax;

B: is the Contractor's "net revenue" from Petroleum Operations for the current tax year;
"Net revenue" of a Contractor for a tax year is the "gross revenue" of the Contractor for the year, less the total deductible expenditure of the Contractor for the Petroleum Operations for that year (this may be negative).

The definition of "gross receipts"[28] is very expansive and it includes but not limited to income accrued for Income Tax purposes and other amounts received by the Contractor but interest income and amounts received or accrued as consideration for the transfer of an interest in Petroleum Operations are excludible.

[28] Sections 20 of the TBUCA Regulations, 14 of the TBUCA.

l: is the interest expense and other financial charges paid by the Contractor in respect of the Petroleum Operations in the current tax year and is entered in the formula as a negative number; and
r: is the rate of corporate Income Tax (30% currently).

The position of the Timor-Leste Tax Administration is that in the ANR equation above, if the component (A x 116.5%) is negative for a tax year, that component cannot be offset by (I x (1-r)), such that the result of ((A x 116.5%) - (I x (1-r))), is lesser than A, in absolute terms.

Example- APT Calculation

Assume the followings for a Contractor named Holland Oil Corporation (HOC) for the tax year ended December 31, 2011:

Gross Revenue (excluding interest income)	US$400,000,000
2011 deductible expenditure (including interest & financial charges	(5,000,000)
Capital expenditure incurred in 2011:	(30,000,000)
Operating expenses in connection with Petroleum Operations	(40,000,000)
CIT @30% on taxable income before deducting SPT	(75,000,000)
Total deductible expenditure for 2011	**$150,000,000**
Net Revenue of the 2011 year ($400m-150m)	250,000,000
Accrued Net Receipts (ANR) as on Dec. 31, 2011	**250,000,000**
ANR after JPDA reduction (ANR X 90%)	**225,000,000**
APT Payable (ANR after JPDA reduction x22.5/70%)	**72,321.428**
APT installments paid during 2011	(70,000,000)
APT due ($72,321,428-70,000)	**$2,321,428**

APT-Payment and Reporting Obligations & Procedure

To the extent that a Contractor is subject to APT, the reporting obligations and procedure is substantially the same as those of Corporate Income Tax. The due date[29] for the APT payment and the informational/tax return is the same as the annual income tax (i.e. 31 March of the year following the affected tax year).

Consistent with the income tax reporting obligations and procedure, Contractors that are subject to APT are mandated to prepare and submit to the Tax Administration an estimated tax liability for the year and make installment payments calculated at 1/12th of the estimated annual APT

[29] Sections 17 of the TBUCA, 23.7 of TBUCA Regulations.

liability, and remit 1/12th on a monthly basis. Just like the monthly installment obligations, the APT monthly tax installment is due on the 15th of each successive month.[30]

APT- Nature of deductible expenditures

It should be noted that the items, nature and categories of permissible deductions for the purposes of calculating the taxable corporate income tax are not the same as those permissible for calculating SPT. The items that are permissible for calculating the APT are:

1. expenditures incurred during the current year by a Contractor in connection with Petroleum Operations but excluding items of *depreciation*, *amortization*, *interest* and other *financing charges*;
2. capital expenditure incurred during the current year for the acquisition or construction of a tangible or intangible asset used in the Petroleum Operations of a Contractor in a particular contract area, excluding any amount paid as *consideration for the acquisition of an interest* in a Petroleum Operations;
3. exploration expenditure incurred by the Contractor during the current year in a particular contract area; and
4. the corporate income tax imposed Section 3.3 of TBUCA, excluding any penalties and or interest imposed under Sections 72-74 of the UNTAET Regulation 2000/18.

[30] Sections 18 of theTBUCA and 24 of the TBUCA Regulations.

User Fee Schedule: Effective August 1, 2013

CATEGORY

1. Private Letter Ruling Requests

(a) Advance Letter Ruling by a Contractor	$1,750
(b) Post-transaction Letter Ruling by a Contractor	$7,500
(c) Advance Letter Ruling by a Subcontractor	$250
(d) Post transaction Letter Ruling by a Subcontractor	$750

2. Change in Accounting/Inventory Method Requests

(a) Accounting Method Change by a Contractor	$2,000
(b) Accounting Method Change by a Subcontractor	$500
(c) Inventory Method Change by a Contractor	$1,500
(d) Inventory Method Change by a Subcontractor	$500

3. Advance Pricing Agreements (APAs)/Multi-lateral APAs

(a) Approval of Advance Pricing Agreement by a Contractor	$10,000
(b) Approval of Advance Pricing Agreement by a Subcontractor	$2,500
(c) Approval of Advance Multi-lateral APAs	$15,000

4. Appeals Against Tax Assessments

(a) Appeals against *additional tax assessments* by a Contractor	$2,000
(b) Appeals against *additional tax assessments* by a Subcontractor	$500

(c) Appeals by Contractors and Subcontractors *not involving additional tax assessments*	$0 (no fee)

5. Certified True Copies of Previously filed Tax Returns

(a) Certified True Copy of previously filed tax return by a Contractor	$200
(b) Certified True Copy of previously filed tax return by a Subcontractor	$50

6. Income Tax/APT/SPT Pre-Filing Agreement

(a) Income tax/APT/SPT pre-filing agreement by a Contractor	$30,000
(b) Income tax pre-filing agreement by a Subcontractor	$3,000

7. Tax Treaty Limitation of Benefit Requests

(a) Request for Competent Authority Assistance by a Contractor	$25,000
(b) Request for Competent Authority Assistance by a Subcontractor	$7,500

8. Request for Extension of time to file Informational Return

(a) Request by a Contractor to file any tax/informational return	$300
(b) Request by a Subcontractor to file any tax/informational return	$75

PROCEDURAL MATTERS

Required certification.
A person seeking a reduced user fee under any of the categories above paragraph must provide to the Timor-Leste Tax Administration the following certification in order to obtain the reduced user fee:

(a) If a person seeking a reduced user fee is a Contractor, the person must certify under oath in the request that its gross income is less than $2,000,000 for the last full taxable year ending before the date the request is filed.

(b) If a person seeking a reduced user fee is a Subcontractor, the person must certify under oath in the request that its gross income is less than $350,000 for the last full taxable year ending before the date the request is filed.

A request for a reduced user fee shall be made by an application to the Timor-Leste Tax Commissioner. The application must contain the following information/documents:

i. The name and the Tax Identification Number of the applicant;
ii. a copy of the tax return filed in the immediate past year before the date of the application for a reduced user fee,
iii. the names of the officers/Directors of the applicant;
iv. a narrative of the background facts and circumstances of the applicant; and
v. the reason why the applicant is unable to pay the prescribed user fee.

The application must be signed by an authorized officer of the applicant. The grant of such application is discretionary and it will largely depend on the peculiar circumstances of the applicant.

Regulation TDA-IX/12: Definitions

"**Accounting**" means a systematic process under the IFRS or a Generally Accepted Accounting Practice, of recording of data and information in respect of assets, liabilities or debt, equity, income and expenditures, and all outlays associated with the acquisition and delivery of goods and services, resulting in a financial report in the form of a balance sheet and profit and loss statement at end of each reporting period

"**Affiliate**" means in respect of a Contractor or Subcontractor (or, if more than one person, in respect of each such person), a person that controls, is controlled by, or is under common control with the Contractor or Subcontractor or any such persons as the case may be;

"**Associate**" in relation to a person means any other person who acts or is likely to act in accordance with the wishes of the person as a result of a connection between the persons or common ownership or control; 3 of the UNTAET Regulation 2000/18; it includes:

a) A natural person and a relative of the natural person;
b) A legal person and any person who owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in the legal person; or
c) Two or more legal person if a third owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in each person;

"**Amount**" includes any value in kind or cash;

"**Air or Sea Transportation Services**" means any transportation of passengers, mail, or goods by air or sea:

a) between two places in Timor-Leste;
b) From a place in Timor-Leste to a place outside Timor-Leste;
c) From a place outside Timor-Leste to a place in Timor-Leste

"**Annual Tax Return**" means a form used by a taxpayer to report the calculation and/or payment of tax due within a tax year

"**Approval**" means a written authorization;

"**Approved Contract**" means a contract made by the Contractor and approved by the responsible Ministry or Designated Authority, as the case may be, as part of a Development Plan;

"**Arm's Length Transaction**" means transactions in which the conditions and or terms imposed between two related parties or associates in their commercial or financial relations are similar to those which would be made between independent enterprises;

"**Audit**" means a series of activities to seek, gather and process data, documents and or information for tax compliance purposes;

"**Bank**" means any legal person licensed to accept deposits, and using such funds, either in whole or in part, to make extensions of credit or investments for the account, and at the risk, of the person carrying on the business;

"**Board**" means the Board of Tax and Customs Appeals established under the UNTAET Regulation 2000/18;

"**Body**" means a type of business organization which may be a limited company, limited partnership, an enterprise owned by the government in whatever name and form, association, cooperative, joint venture or similar arrangement, permanent establishment and other such business enterprise;

"**Carry Forward Loss**" means a loss carried forward under Section 73 of the Taxes and Duties Act, 2005, excluding interest expense carryover under Section 74.3 of the Taxes and Duties Act;

"**Code**" means the Petroleum Mining Code agreed and adopted by Timor-Leste and Australia under Article 7 of the Timor Sea Treaty, as amended, varied, modified, or replaced from time to time, and the regulations or orders made thereunder;

"**Commissioner**" means the Commissioner or the Director General of the Directorate of Revenue and Customs of the Ministry of Finance Timor-Leste;

"**Contract Area**" means the area that is subject of a Petroleum Agreement and, if any part of a Contract Area is relinquished pursuant to a Petroleum Agreement, the Contract Area is the Contract Area originally granted;

"**Contractor**" means a person with whom the responsible Ministry or Designated Authority, as the case may be, has made a Petroleum Agreement;

"**Contro**l" means in relation to a person, the power of another person to secure:

a) by means of the holding of shares or the possession of voting power, in or in relation to the first person or any other person; or
b) by virtue of any power conferred by the articles of association of, or any other document regulating, the first person or any other person,

that the affairs of the first person are conducted in accordance with the wishes or directions of that other person;

'**Controlled Taxpayer**" means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers;

"**Controlled transaction or controlled transfer**" means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term uncontrolled transaction means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers;

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"**Crude Oil**" means crude mineral oil and all liquid hydrocarbons in their natural state or obtained from Natural Gas by condensation or extraction;

"**Customs Controller**" means the Controller of the *Customs Service*;

"**Customs Service**" means the Timor-Leste Customs Service;

"**Customs Value**" means the fair market value of the *goods* including cost, insurance and freight as determined in accordance with article VII of GATT, or any amendments thereunder;

"**Crude Oil**" means crude mineral oil and all liquid hydrocarbons in their natural state or obtained from Natural Gas by condensation or extraction;

"**Decommissioning Plan**" means the Decommissioning Plan approved the responsible Ministry or Designated Authority, as the case may be, under a Petroleum Agreement;

"**Decommissioning Security Agreement**" means the Decommissioning Security Agreement approved by the responsible Ministry or Designated Authority, as the case may be, under a Petroleum Agreement;

"Depreciable Asset" means any tangible movable property that:
(a) has a useful life exceeding one year;
(b) is likely to lose value as a result of wear and tear, exploitation, or obsolescence; and
(c) is wholly or partly or substantially used in the conduct of taxable activities;

"**Designated Authority**" means the Designated Authority established under Article 6 of the Timor Sea Treaty;

"**Designation Notice**" is a notice described in Section 68 of UNTAET Regulation 2000/18;

"**Development Expenditure**" means expenditure incurred, after the responsible Ministry or Designated Authority has approved a Development Plan, in preparing a site for Petroleum Operations, including drilling and completing production wells, and the construction of production facilities, but does not include any expenditure incurred in the acquisition or construction of a pipeline or in the acquisition of a depreciable asset;

"**Development Plan**" means the plan for the development and production of petroleum or gas resources in the Contract Area approved by the responsible Ministry or Designated Authority, as the case may be;

"**Dividend**" means any distribution of profit from current year or from accumulated earnings by a legal person to a member as a result of participation in the capital of the legal person, including:

a) Any amount returned to a member in respect of a membership interest in a legal person on a partial reduction in capital to the extent that the amount returned exceeds the amount or value by which the nominal value of the membership interest was reduced; or
b) Any amount distributed to a member on redemption or cancellation of a membership interest, including liquidation, to the extent the amount distributed exceeds the nominal value of the membership interest;

"**Employee**" means:
a) a natural person who is in employment; or
b) a natural person whose provision of services is substantially similar to the provision of services by a person who is in employment

"**Employer**" means a *person* who hires an employee pays periodic *wages* to an *employee*;

"**Employment in Timor-Leste**" means the provision of personal services in Timor-Leste:

(a) in the course of an *employer* and *employee* relationship;
(b) as director of a company;
(c) as the holder of a public office; or
(d) as an official of the government of Timor-Leste posted overseas;

"**Exploration Expenditure**" means expenditure relating to and connected with geological, geophysical and geochemical surveys, exploration or appraisal drilling, or feasibility and environmental impact studies incurred in conducting Petroleum Operations prior to the grant of an approval of the Development plan by the responsible Ministry or Designated Authority, as the case may be;

"**Field Export Point**" means the point at which petroleum from a Contract Area leaves the Contract Area, or such earlier point at which it is loaded onto or enters a vessel, pipeline, or other means of transportation to be transported from the Contract Area;

"**Financial institution**" means any licensed bank or other licensed legal person that is primarily engaged in the business of making credit extensions or investments for the account, and the risk, of the person carrying on the business;

"**Goods**" means any substance, organism, article or thing, whether manufactured or natural, which is not a human body, cadaver or human remains;

"**Head Office Expenditures**" means any executive, management, or general administration expenditures incurred by a non-resident person in the ordinary course of business, and which expenses are incurred solely and primarily for business purpose and for the benefit of the permanent establishment of the person in Timor-Leste;

"**Intangible Asset**" means any property, other than tangible movable or immovable property, that:

a) has a useful life exceeding one year;
b) is used wholly or substantially in the conduct of taxable business activities;

"**Intangible expenditure**" means any expenditure incurred other than in the acquisition of any tangible movable or immovable property, or tangible asset;

"**Interest**" means:

a) any amount (including a premium or original issue discount) paid or accrued under a debt obligation that is not a repayment of capital and pursuant to petroleum operations; or
b) any amount that is functionally equivalent to an amount referred to in paragraph (a), such as amount paid or accrued under an interest rate swap agreement or as defaulted under a guarantee agreement, pursuant to petroleum operations;
c) any commitment, guarantee, service, or similar fee payable in respect of a debt obligation or other instrument or agreement giving rise to interest under paragraphs (a) or (b);

For the purposes of Section 74 of the Taxes and Duties Act, 2008 as amended or modified, the interest referred to in paragraphs (a)-(c) must be charged by a bank.

"**International Financial Reporting Standards**" means the most recent International Financial Reporting Standards issued by the International Accounting Standards Board or any successor entity taking over the role of issuing International Financial Reporting Standards;

"**Law on Income Tax**" means the Taxes and Duties Act, 2008, including any amendments and Regulations thereunder, and such other laws applicable in Timor-Leste under UNTAET Regulation No. 1999/1;

"**Legal Person**" means:

a) any limited liability company, joint stock company, general partnership, limited partnership, or other unincorporated association or body of persons, whether incorporated, formed, organized, or established in Timor-Leste or elsewhere;
b) any trust, undivided estate of a deceased natural person;
c) a government, a political or administrative subdivision of a government in whatever name or form, or public international organisation, or an entity, organisation, association, or business form owned by a government, political subdivision of a government, or public international organisation;

"**Long-Term Contract**" is a contract for manufacture, installation, maintenance, or construction, or services related thereto, that is not completed in the tax year in which work under the contract commenced, other than a contract estimated to be completed within six months of the date on which work under the contract commenced;

"Management Services" means the provision of managerial services, consulting, supervisory or other similar services for a fee between related parties;

"**Member**" in relation to a legal person means a shareholder, partner in a partnership, or any other person with a membership interest in a legal person;

"**Method of Accounting**" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item;

"**Mining**" means any method or process by which any mineral is taken from the soil or from any substance or constituent of the soil;

"**Mining Support services**" means every service relating to mining other than technical, management, consulting, or architectural services;

"**Natural Gas**" means all gaseous hydrocarbons and inerts, including wet mineral gas, dry mineral gas, casing head gas, and residue gas remaining after the extraction of liquid hydrocarbons from wet gas, but not crude oil;

"**Natural Resources**" means any mineral, petroleum, or any other living or non-living resource that may be taken from the land or sea;

"**Non-Resident Person**" means any person who is not present in Timor-Leste for a period of, or periods in aggregate to, one hundred and eighty three days or more in the tax year in aggregate;

"**Non-Wage Benefits**" means any reward for services provided by an *employer* to an *employee*, including:

(a) the market value of any non-cash benefit provided by an *employer* to an *employee*;
(b) the value determined by the *Commissioner* of the provision by the *employer* to an *employee* of the use of a motor vehicle wholly or partly for private purposes of the *employee*;
(c) the value determined by the *Commissioner* of the provision by the *employer* of accommodation or housing;
(d) the value determined by the *Commissioner* of the provision by an *employer* to an *employee* of a housekeeper, driver, guard, gardener, or other domestic assistant; and
(e) the cost to the *employer* of providing an *employee* with any meal, refreshment, or entertainment except in the course of providing a *good* or service for the *employer* where the *Commissioner* considers that the cost of provision for the *employer* is reasonable;

"**Permanent Establishment**" means:

(a) a place of management;

(b) a branch;
(c) a representative office;
(d) an office;
(e) a factory;
(f) a workshop;
(g) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources, including any place of drilling for mineral exploration;
(h) a fishery, place where animal husbandry is conducted, farm, plantation, or forest'
(i) a construction, installation, or assembly project;
(j) the furnishing of services through employees or other personnel, if conducted for more than sixty days in any 12-month period;
(k) a natural legal person acting as a dependent agent; or
(l) an agent or employee of a non-resident insurance company, if the agent or employee collects premium, or insures risks, in Timor-Leste;

"**Person**" means:

(a) a natural person, including a sole trader;
(b) a company, wherever incorporated, or other juridical person;
(c) a partnership, wherever formed;
(d) a trust, wherever established; or
(e) any other unincorporated association or body of persons;

"**Petroleum**" means:

(a) any naturally occurring hydrocarbon, whether in a gaseous, liquid or solid state;
(b) any mixture of naturally occurring hydrocarbons, whether in a gas, liquid or solid state; or
(c) any petroleum (as defined above) that has been returned to the reservoir;

"**Petroleum Agreement**" means

(a) a contract, licence, permit, or other authorization in relation to petroleum operations made or given pursuant to the Timor-Leste Petroleum Act, except Seepage Use Authorisation; or
(b) an authorisation or production sharing contract made under the Code;

"**Petroleum Operations**" means authorized activities under a Petroleum Agreement;

"**Reserves**" means the estimated quantity of petroleum or gas that can be expected to be profitably extracted, processed, and sold under the current and foreseeable economic conditions;

"**Reservoi**r" means an accumulation of petroleum in a geological unit limited by rock, water or other substances without pressure communication through liquid or gas to another accumulation of petroleum;

"**Resident**" in respect of a natural person means:
a natural person who is present in Timor-Leste for more than 183 days in a tax year unless the person's permanent place of abode is not in Timor-Leste;

"**Royalty**" means any amount, however described or computed, whether periodical or not, as consideration for:

(a) the use or right to use any copyright, patent, design, or model, secret formula or process, trademark, or other like property;
(b) the use or right to use any motion picture films, films or video tapes for use in connection with television or internet broadcasting, or tapes for use in connection with radio or internet broadcasting;
(c) the receipt of, or right to receive, any visual images or sounds, or both, transmitted by satellite, cable, optic fiber, or similar technology in connection with television, radio, or internet broadcasting;
(d) the supply of any scientific, technical, industrial, or commercial knowledge or information;
(e) the use of or right to use any tangible movable property;
(f) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property, supply, or right as mentioned in paragraphs (a)-(e);
(g) the partial or total forbearance in respect of any matter referred to in paragraphs (a)-(f); or
(h) the disposal of any property or right referred to in paragraphs (a)-(g);

"**Sales Tax Value**" means:

(a) for imported taxable *goods*, the *customs value* of *goods* increased by any import duty and excise tax payable on the importation of the *goods*;
(b) for taxable goods sold in Timor-Leste, the price of the *goods* not including any sales tax; and
(c) for taxable services provided in Timor-Leste, the price of the service not including any sales tax;

"**Seepage Use Authorisation**" has the meaning in the Timor-Leste Petroleum Act;

"**Services**" includes the hiring of equipment;

"**State-Owned Contractor**" means the Contractor incorporated under the laws of Timor-Leste, which is controlled directly or indirectly, by Timor-Leste;

"**Subcontractor**" means any person supplying goods or services directly or indirectly to a Contractor in respect of Petroleum Operations;

"**Tax Administration**" means the National Directorate of Petroleum Revenuer or any other public bodies or central services charged under the laws of Timor-Leste to carry out the

enforcement of petroleum tax laws and collect petroleum taxes and duties, Commissioner or the Minister of Finance or another competent member of the Government, when exercising their administrative power in relation to tax matters, including policies and regulations;

"T**axpayer**" is anybody, individual or corporate, who or which, pursuant to the provisions in the tax laws, is required to fulfill tax obligations, including tax withholders of certain taxes be it income or wages related, those required to make tax payments in relation to oil and gas business in certain designated areas but excluding the Annex part of the Joint Production Development Area;

"**Tax Assessment**" means understatement of tax and or underpayment of tax including interest and any additional tax imposed under Sections 72, 73 and 74 of UNTAET Regulation 2000/18;

"**Taxable Business Activities**" means business activities carried on to derive business income and which is includible in gross income;

"**Tax Form**" means:

(a) an annual income tax form, including all the required information and or data;
(b) an annual Supplemental petroleum tax form, including all the required information and or data;
(c) an annual wage income tax withholding information form, including all the required information and or data;
(d) an excise tax form;
(e) the income and Supplemental petroleum tax instalment forms, ;
(f) an income tax withholding form;
(g) a sales tax form;
(h) a services tax form;
(i) a wage income tax withholding form;
(j) any forms designated by the *Commissioner* for the purposes of *persons* applying for tax identification numbers and being registered for tax purposes;
(k) any forms designated by the *Commissioner* under Section 45.1(c); or
(l) any consolidated form designated by the *Commissioner* which includes the information from 2 or more of the above forms;

provided that where, in relation to any *person*, any consolidated form has been designated by the *Commissioner*, then the forms which that consolidated form has replaced shall no longer be "tax forms";

"**Tax Period**" means a calendar month or calendar year, unless otherwise stipulated by the Commissioner and or the Minister of Finance, as the case may be;

"**Tax Return**" means a form designated as such by the Commissioner under Section 42 of UNTAET Regulation 2000/18 or described in Section 3 of the UNTAET Regulation 2000/18, including all the required information and or data or a form used by a Taxpayer to report the calculation and payment of tax due pursuant to the provisions of the applicable tax laws;

"**Tax Treaty**" means:

(a) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a sovereign country providing for the relief from double taxation and the prevention of fiscal evasion; or
(b) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a foreign country providing for reciprocal assistance in the enforcement of income tax liabilities;

"**Tax Year**" means the 12 month period from 1 January to 31 December, or if a taxpayer has permission to use a substituted tax year, the substituted tax year;

"**Timor-Leste**", when referring to a geographic area, means the territory of Timor-Leste and its territorial waters, the economic zone off the coast of Timor-Leste recognized under the law of the sea and, to the extent allowed by treaty;

"**Timor-Leste Petroleum Act**" means the Timor-Leste Petroleum Act, 2004 as amended, varied, modified, or replaced from time to time, and includes any regulations and amendments made under the Act;

"**Timor Sea Treaty**" means the Timor Sea Treaty dated 20 May 2002 between the Government of the Democratic Republic of Timor-Leste and the Government of Australia;

"**Total Approved Decommissioning Costs**" means the total decommissioning costs approved by the responsible Ministry or Designated Authority in writing, as the case may be, in accordance with the Decommissioning Plan provided under the Petroleum Agreement, as revised or amended from time to time;

"**Transaction**" means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer;

"**True taxable income**" means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto);

"**Uncontrolled comparable**" means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology.

"**Uncontrolled taxpayer**" means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests;

"**Underlying Ownership**" in relation to a legal person, means a membership interest in the person held, directly or indirectly through an interposed legal person or persons, by a natural person or by a person not ultimately owned by natural persons;

"**Wages**" means any reward for services provided by an *employer* to an *employee*, including:

(a) any salary provided to the *employee*, including leave pay, overtime payments, commissions, and bonuses;
(b) director's fees;
(c) the value of gifts provided by an *employer* to an *employee*;
(d) any allowance provided by the *employer* for the benefit of an *employee*;
(e) any payment provided by the *employer* in respect of loss or termination of employment;
(f) any payments however described made on termination of employment in respect of entitlements outstanding at the time of termination;
(g) the reimbursement or discharge by an *employer* of any expense of the *employee* including utilities expenses;
(h) the amount of any reimbursement or discharge by an *employer* of an *employee*'s medical expenses;
(i) the amount of any waiver where any *employer* waives an obligation of the *employee* to pay an amount owing to the *employer*; and
(j) *Non-wage benefits* greater than $20 provided in a calendar month to *employees* of an *employer* that is exempt from income tax;

"Verification" is a series of steps undertaken to evaluate the completeness and accuracy of an information provided to the Commissioner and or the tax administration of Timor-Leste.

Taxation of Bayu-Undan Contractors) Regulations: Definitions

"**Accounting**" means a systematic process under the IFRS or a Generally Accepted Accounting Practice, of recording of data and information in respect of assets, liabilities or debt, equity, income and expenditures, and all outlays associated with the acquisition and delivery of goods and services, resulting in a financial report in the form of a balance sheet and profit and loss statement at end of each reporting period

"**Affiliate**" means in respect of a Contractor (or, if more than one person, in respect of each such person), a person that controls, is controlled by, or is under common control with the Contractor;

"**Associate**" in relation to a person means any other person who acts or is likely to act in accordance with the wishes of the person as a result of a connection between the persons or common ownership or control; it includes:

d) A natural person and a relative of the natural person;
e) A legal person and any person who owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in the legal person; or
f) Two or more legal person if a third owns directly or indirectly 50% or more, by value or number, of the capital or voting rights in each person;

"**Amount**" includes any value in kind or cash;

"**Air or Sea Transportation Services**" means any transportation of passengers, mail, or goods by air or sea:

d) between two places in Timor-Leste;
e) From a place in Timor-Leste to a place outside Timor-Leste;
f) From a place outside Timor-Leste to a place in Timor-Leste

"**Annual Tax Return**" means a form used by a taxpayer to report the calculation and/or payment of tax due within a tax year as prescribed by the Commissioner and or the Tax Administration;

"**Approval**" means a written authorization by the authorizing organization, body or person;

"**Approved Contract**" means a contract made by the Contractor and approved by the responsible Ministry or Designated Authority, as the case may be, as part of a Development Plan;

"**Arm's Length Transaction**" means transactions in which the conditions and or terms imposed between two related parties or associates in their commercial or financial relations are similar to those which would be made between independent and unrelated enterprises;

"**Audit**" means a series of activities to seek, gather and process data, documents and or information for tax compliance purposes;

"**Bank**" means any legal person licensed to accept deposits, and using such funds, either in whole or in part, to make extensions of credit or investments for the account, and at the risk, of the person carrying on the business;

"Bayu-Undan" is the discovered part of the Bayu-Undan field, as defined and designated in the Production Sharing Contracts JPDA 03-12 and JPDA 03-13;

"**Board**" means the Board of Tax and Customs Appeals established under the UNTAET Regulation 2000/18, including any amendments;

"**Body**" means a type of business organization which may be a limited company, limited partnership, an enterprise owned by the government in whatever name and form, association, cooperative, joint venture or similar arrangement, permanent establishment and other such business enterprise;

"**Carry Forward Loss**" means a loss carried forward under Article 6(2) of the Law on Income Tax;

"**Code**" means the Petroleum Mining Code agreed and adopted by Timor-Leste and Australia under Article 7 of the Timor Sea Treaty, as amended, varied, modified, or replaced from time to time, and the regulations or orders made thereunder;

"**Commissioner**" means the Commissioner or the Director General of the Directorate of Revenue of the Ministry of Finance, Timor-Leste;

"**Contract Area**" means the area that is subject of a Petroleum Agreement and, if any part of a Contract Area is relinquished pursuant to a Petroleum Agreement, the Contract Area is the Contract Area originally granted;

"**Contractor**" means a person deemed to be a taxpayer who:

(a) has entered into the Production Sharing Contract JPDA 03-12 or JPDA 03-13, or a Production Sharing Contract superseding the previous ones, in accordance with Annex F of the Timor Sea Treaty; or
(b) succeeds to a taxpayer mentioned in paragraph (a) above, or who is an assignee thereof, under the terms provided for by the Production Sharing Contract JPDA 03-12 and or JPDA 03-13, as the case may be., and who is registered as a Contractor under the terms of the Petroleum Mining Code; and
(c) any other person who has entered into a Production Sharing Contract with the Designated Authority or the responsible Ministry, within the Annex F part of the JPDA;

"**Control**" means in relation to a person, the power of another person to secure:

c) by means of the holding of shares or the possession of voting power, in or in relation to the first person or any other person; or
d) by virtue of any power conferred by the articles of association of, or any other document regulating, the first person or any other person, that the affairs of the first person are conducted in accordance with the wishes or directions of that other person;

'**Controlled Taxpayer**" means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers;

"**Controlled transaction or controlled transfer**" means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term uncontrolled transaction means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers;

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"**Crude Oil**" means crude mineral oil and all liquid hydrocarbons in their natural state or obtained from Natural Gas by condensation or extraction;

"**Customs Controller**" means the Controller of the *Customs Service*;

"**Customs Service**" means the Timor-Leste Customs Service;

"**Customs Value**" means the fair market value of the *goods* including cost, insurance and freight as determined in accordance with article VII of GATT, or any amendments thereunder;

"**Deactivation Costs**" means the expenses approved under a Decommissioning Plan by the responsible Ministry or Designated Authority, as the case may be, under a Petroleum Agreement;

"**Deactivation Plan"** in respect of a petroleum project means, the Deactivation Plan approved in writing by the Designated Authority pursuant to the Production Sharing Contract that regulates a petroleum project, entered into between the Designated Authority and the Contractor;

"Depreciable Asset" means any tangible movable property that:
(d) has a useful life exceeding one year (12 months);
(e) is likely to lose value as a result of wear and tear, exploitation, or obsolescence; and
(f) is wholly or substantially used in the conduct of taxable activities;

"**Designated Authority**" means the Designated Authority established under Article 6 of the Timor Sea Treaty;

"**Designation Notice**" is a notice described in Section 68 of UNTAET Regulation 2000/18;

"**Development Expenditure**" means expenditure incurred, after the responsible Ministry or Designated Authority has approved a Development Plan, in preparing a site for Petroleum Operations, including drilling and completing production wells, and the construction of

production facilities, but does not include any expenditure incurred in the acquisition or construction of a pipeline or in the acquisition of a depreciable asset;

"**Development Plan"** in respect of a petroleum project means, a Development Plan approved by the Designated Authority pursuant to the Production Sharing that regulates a petroleum project, entered into between the Designated Authority and the Contractor

"**Dividend**" means any distribution of profit from current year or from accumulated earnings by a legal person to a member as a result of participation in the capital of the legal person, including:

c) Any amount returned to a member in respect of a membership interest in a legal person on a partial reduction in capital to the extent that the amount returned exceeds the amount or value by which the nominal value of the membership interest was reduced; or
d) Any amount distributed to a member on redemption or cancellation of a membership interest, including liquidation, to the extent the amount distributed exceeds the nominal value of the membership interest;

"Elang Kakatua Kakatua North" means the discovered area Elang Kakatua Kakatua North, as defined in Production Sharing Contract JPDA 03-12;

"**Exploration Expenditure**" means expenditure relating to and connected with geological, geophysical and geochemical surveys, exploration or appraisal drilling, or feasibility and environmental impact studies incurred in conducting Petroleum Operations prior to the grant of an approval of the Development plan by the responsible Ministry or Designated Authority, as the case may be;

"Export Pipeline" means an export pipeline as defined in the Production Sharing Contracts JPDA 03-12 and JPDA 03-13;

"**Field Export Point**" means the point at which petroleum from a Contract Area leaves the Contract Area, or such earlier point at which it is loaded onto or enters a vessel, pipeline, or other means of transportation to be transported from the Contract Area;

"**Financial institution**" means any licensed bank or other licensed legal person that is primarily engaged in the business of making credit extensions or investments for the account, and the risk, of the person carrying on the business;

"**Goods**" means any substance, organism, article or thing, whether manufactured or natural, which is not a human body, cadaver or human remains;

"**Head Office Expenditures**" means any executive, management, or general administration expenditures incurred by a non-resident person in the ordinary course of business, and which expenses are incurred solely and primarily for business purpose and for the benefit of the permanent establishment of the person in Timor-Leste;

"**Intangible Asset**" means any property, other than tangible movable or immovable property, that:

c) has a useful life exceeding one year;
d) is used wholly or substantially in the conduct of taxable business activities;

"**Intangible expenditure**" means any expenditure incurred other than in the acquisition of any tangible movable or immovable property, or tangible asset;

"**Interest**" means:

d) any amount (including a premium or original issue discount) paid or accrued under a debt obligation that is not a repayment of capital and pursuant to petroleum operations; or
e) any amount that is functionally equivalent to an amount referred to in paragraph (a), such as amount paid or accrued under an interest rate swap agreement or as defaulted under a guarantee agreement, pursuant to petroleum operations;
f) any commitment, guarantee, service, or similar fee payable in respect of a debt obligation or other instrument or agreement giving rise to interest under paragraphs (a) or (b);

"**International Financial Reporting Standards**" means the most recent International Financial Reporting Standards issued by the International Accounting Standards Board or any successor entity taking over the role of issuing International Financial Reporting Standards;

"Joint Commission" means the Joint Commission established pursuant to Article 6 of the Timor Sea Treaty;

"**Law on Income Tax**" means the Law on Income Tax, applicable in Timor-Leste as defined under UNTAET Regulation No. 1999/1

"**Law on Income Tax Regime and Procedures**" means the Law on the General Tax Regime and Procedures applicable in Timor-Leste, under the terms of the UNTAET Regulation No. 1999/1;

"**Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods**" means the Law on Value Added Tax on Goods and Services and Sales Tax on Luxury Goods, applicable in Timor-Leste, under the terms of UNTAET Regulation No. 1999/1;

"**Legal Person**" means:

d) any limited liability company, joint stock company, general partnership, limited partnership, or other unincorporated association or body of persons, whether incorporated, formed, organized, or established in Timor-Leste or elsewhere;
e) any trust, undivided estate of a deceased natural person;

f) a government, a political or administrative subdivision of a government in whatever name or form, or public international organisation, or an entity, organisation, association, or business form owned by a government, political subdivision of a government, or public international organisation;

"**Long-Term Contract**" is a contract for manufacture, installation, maintenance, or construction, or services related thereto, that is not completed in the tax year in which work under the contract commenced, other than a contract estimated to be completed within six months of the date on which work under the contract commenced;

"Management Services" means the provision of managerial services, consulting, supervisory or other similar services for a fee between related parties;

"**Member**" in relation to a legal person means a shareholder, partner in a partnership, or any other person with a membership interest in a legal person;

"**Method of Accounting**" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item;

"**Mining**" means any method or process by which any mineral is taken from the soil or from any substance or constituent of the soil;

"**Mining Support services**" means every service relating to mining other than technical, management, consulting, or architectural services;

"**Natural Gas**" means all gaseous hydrocarbons and inerts, including wet mineral gas, dry mineral gas, casing head gas, and residue gas remaining after the extraction of liquid hydrocarbons from wet gas, but not crude oil;

"**Natural Resources**" means any mineral, petroleum, or any other living or non-living resource that may be taken from the land or sea;

"**Non-Resident Person**" means any person who is not present in Timor-Leste for a period of, or periods in aggregate to, one hundred and eighty three days or more in the tax year in aggregate;

"**Non-Wage Benefits**" means any reward for services provided by an *employer* to an *employee*, including:

(a) the market value of any non-cash benefit provided by an *employer* to an *employee*;
(b) the value determined by the *Commissioner* of the provision by the *employer* to an *employee* of the use of a motor vehicle wholly or partly for private purposes of the *employee*;
(c) the value determined by the *Commissioner* of the provision by the *employer* of accommodation or housing;

(d) the value determined by the *Commissioner* of the provision by an *employer* to an *employee* of a housekeeper, driver, guard, gardener, or other domestic assistant; and

(e) the cost to the *employer* of providing an *employee* with any meal, refreshment, or entertainment except in the course of providing a *good* or service for the *employer* where the *Commissioner* considers that the cost of provision for the *employer* is reasonable;

"**Overall Deactivated Costs Approved**" means the total deactivation costs approved by the Designated Authority in writing, in accordance with the Deactivation or Decommissioning Plan for a petroleum project, including revisions and or amendments to date;

"**Person**" means:

(f) a natural person, including a sole trader;
(g) a company, wherever incorporated, or other juridical person;
(h) a partnership, wherever formed;
(i) a trust, wherever established; or
(j) any other unincorporated association or body of persons;

"Percentage Transfer Factor" under Sections 13 of the present Regulations and 16 of the Taxation of Bayu-Undan Contractors Act means the percentage of the right or stake held by the transferring or assigning Contractor, in a petroleum project, which is either transferred or assigned, divided by the total percentage of the right or stake held by the transferring or assigning Contractor in the petroleum project immediately before the occurrence of the transfer or assignment;

"**Petroleum**" means:

(d) any naturally occurring hydrocarbon, whether in a gaseous, liquid or solid state;
(e) any naturally occurring mixture of hydrocarbons, whether in a gaseous, liquid or solid state; or
(f) any naturally occurring mixture of one or more hydrocarbons, whether in a gaseous, liquid or solid state, as well as other substances produced in association with such hydrocarbons, and includes any petroleum as defined by paragraphs (a), (b) and (c) as defined above, that has been returned to the reservoir;

"**Petroleum Agreement**" means

(c) a contract, licence, permit, or other authorization in relation to petroleum operations made or given pursuant to the Timor-Leste Petroleum Act, except Seepage Use Authorisation; or
(d) an authorisation or production sharing contract made under the Code;

"**Petroleum Project**" means authorized activities in Bayu-Undan, with the exception of Elang Kakatua Kakatua North, under a Petroleum Agreement;

"**Reserves**" means the estimated quantity of petroleum or gas that can be expected to be profitably extracted, processed, and sold under the current and foreseeable economic conditions;

"**Reservoi**r" means an accumulation of petroleum in a geological unit limited by rock, water or other substances without pressure communication through liquid or gas to another accumulation of petroleum;

"**Resident**" in respect of a natural person means:
a natural person who is present in Timor-Leste for more than 183 days in a tax year unless the person's permanent place of abode is not in Timor-Leste;

"**Royalty**" means any amount, however described or computed, whether periodical or not, as consideration for:

(i) the use or right to use any copyright, patent, design, or model, secret formula or process, trademark, or other like property;
(j) the use or right to use any motion picture films, films or video tapes for use in connection with television or internet broadcasting, or tapes for use in connection with radio or internet broadcasting;
(k) the receipt of, or right to receive, any visual images or sounds, or both, transmitted by satellite, cable, optic fiber, or similar technology in connection with television, radio, or internet broadcasting;
(l) the supply of any scientific, technical, industrial, or commercial knowledge or information;
(m) the use of or right to use any tangible movable property;
(n) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property, supply, or right as mentioned in paragraphs (a)-(e);
(o) the partial or total forbearance in respect of any matter referred to in paragraphs (a)-(f); or
(p) the disposal of any property or right referred to in paragraphs (a)-(g);

"**Sales Tax Value**" means:

(d) for imported taxable *goods*, the *customs value* of *goods* increased by any import duty and excise tax payable on the importation of the *goods*;
(e) for taxable goods sold in Timor-Leste, the price of the *goods* not including any sales tax; and
(f) for taxable services provided in Timor-Leste, the price of the service not including any sales tax;

"**Seepage Use Authorisation**" has the meaning in the Timor-Leste Petroleum Act;

"**Services**" includes the hiring of equipment;

"**Subcontractor**" means any person supplying goods or services directly or indirectly to a Contractor in respect of a petroleum project;

"**Tax Administration**" means the National Directorate of Petroleum Revenue or any other public bodies or central services charged under the laws of Timor-Leste to carry out the enforcement of petroleum and mineral tax laws and collect petroleum and mineral taxes and duties, Commissioner or the Minister of Finance or any other competent member or organ of the Government, when exercising their administrative and or statutory power in relation to tax matters, including policies and regulations;

"T**axpayer**" is anybody, individual or corporate, who or which, pursuant to the provisions in the tax laws, is required to fulfill tax obligations (including filing of periodic information returns and registration with the Tax Administration of Timor-Leste, and who are compliant), persons required to withhold certain withholding taxes, be it income or wages-related and remit same to the Timor-Leste Tax Administration and persons who are deemed to be Contractor or Subcontractor and carrying on oil and gas business within the Annex F part of the Joint Production Development Area;

"**Tax Assessment**" means understatement of tax and or underpayment of tax including interest and any additional tax imposed under Sections 72, 73 and 74 of UNTAET Regulation 2000/18; the Law on Income Tax, the Law on the General Tax Regime and Procedures (to the extent applicable in Timor-Leste) and the present Regulations;

"**Taxable Business Activities**" means business activities carried on to derive business income and which is includible in gross income;

"Tax Collection Notice or Notice of Assessment" means a form for the imposition and collection of tax and or additional or administrative penalties either in the form of interest, fines etc;

"Tax Correction Notice" means a notice correcting errors in writing or calculation and or errors in the application of relevant principles or provisions of tax laws in connection with a tax return or Tax Collection Notice or Notice of Assessment;

"**Tax Form**" means:

(m) an annual income tax form, including all the required information and or data;
(n) an annual Additional Petroleum Tax form, including all the required information and or data;
(o) an annual wage income tax withholding information form, including all the required information and or data;
(p) an excise tax form;
(q) the income and Additional Petroleum tax instalment forms, ;
(r) an income tax withholding form;
(s) a sales tax form;

(t) a services tax form;
(u) a wage income tax withholding form;
(v) any forms designated by the *Commissioner* for the purposes of *persons* applying for tax identification numbers and being registered for tax purposes;
(w) any forms designated by the *Commissioner* under Section 45.1(c) of the UNTAET Regulation 2000/18; or
(x) any consolidated form designated by the *Commissioner* which includes the information from 2 or more of the above forms;

provided that where, in relation to any *person*, any consolidated form has been designated by the *Commissioner*, then the forms which that consolidated form has replaced shall no longer be "tax forms";

"**Tax Period**" means a calendar month or calendar year, unless otherwise stipulated by the Commissioner and or the Minister of Finance, as the case may be;

"**Tax Return**" means a form designated as such by the Commissioner under Section 42 of UNTAET Regulation 2000/18 or described in Section 3 of the UNTAET Regulation 2000/18, including all the required information and or data or a form used by a Taxpayer to report the calculation and payment of tax due pursuant to the provisions of the applicable tax laws;

"**Tax Treaty**" means:

(c) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a sovereign country providing for the relief from double taxation and the prevention of fiscal evasion; or
(d) an agreement between the Government of the Democratic Republic of Timor-Leste and the government of a foreign country providing for reciprocal assistance in the enforcement of income tax liabilities;

"**Tax Year**" means the 12 month period from 1 January to 31 December, or if a taxpayer has permission to use a substituted tax year, the substituted tax year;

"**Timor-Leste**", when referring to a geographic area, means the territory of Timor-Leste and its territorial waters, the economic zone off the coast of Timor-Leste as defined in Section 4 of the Constitution of the Democratic Republic of Timor-Leste and recognized under the law of the Sea and by any Treaty Of Timor-Leste;

"**Timor-Leste Petroleum Act**" means the Timor-Leste Petroleum Act, 2004 as amended, varied, modified, or replaced from time to time, and includes any regulations and amendments made under the Act;

"**Timor Sea Treaty**" means the Timor Sea Treaty dated 20 May 2002 between the Government of the Democratic Republic of Timor-Leste and the Government of Australia;

"**Transaction**" means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer;

"**True taxable income**" means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto);

"**Uncontrolled comparable**" means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology.

"**Uncontrolled taxpayer**" means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests;

"**Underlying Ownership**" in relation to a legal person, means a membership interest in the person held, directly or indirectly through an interposed legal person or persons, by a natural person or by a person not ultimately owned by natural persons;

"**Wages**" means any reward for services provided by an *employer* to an *employee*, including:

(a) any salary provided to the *employee*, including leave pay, overtime payments, commissions, and bonuses;
(b) director's fees;
(c) the value of gifts provided by an *employer* to an *employee*;
(d) any allowance provided by the *employer* for the benefit of an *employee*;
(e) any payment provided by the *employer* in respect of loss or termination of employment;
(f) any payments however described made on termination of employment in respect of entitlements outstanding at the time of termination;
(g) the reimbursement or discharge by an *employer* of any expense of the *employee* including utilities expenses;
(h) the amount of any reimbursement or discharge by an *employer* of an *employee*'s medical expenses;
(i) the amount of any waiver where any *employer* waives an obligation of the *employee* to pay an amount owing to the *employer*; and
(j) *Non-wage benefits* greater than $20 provided in a calendar month to *employees* of an *employer* that is exempt from income tax;

"Verification" is a series of steps undertaken to evaluate the completeness and accuracy of an information provided to the Commissioner and or the tax administration of Timor-Leste.