



REPÚBLICA DEMOCRÁTICA DE TIMOR LESTE
MINISTÉRIO DAS FINANÇAS
DIRECÇÃO GERAL DE RECEITAS E ALFÂNDEGAS
DIRECÇÃO NACIONAL RECEITAS PETROLIFERAS



B

Adianta o Futuro. Bem-vindo Desenvolvimento

Public Ruling: Treatment of pre-2005 cost for the purposes of Income Tax under the Taxes and Duties Act, the Supplemental Petroleum Tax calculation under the Petroleum Taxation Act 2005 & the Taxes and Duties Act in the Joint Production Development Area (non-Annex F)

National Directorate of Petroleum Revenue (NDPR) Public Ruling 2011/02

Relying on this Ruling

This is a public ruling within the meaning of section 66 of UNTAET Regulation 2000/18. Information in this ruling may be relied upon by PSC contractor taxpayers subject to Supplemental Petroleum Tax under Petroleum Taxation Act 2005 and Taxes and Duties Act 2008 as the basis for the determination of their Supplemental Petroleum Tax liability in Timor-Leste.

For Timor-Leste Income Tax purposes, the ruling also stipulates the apportionment factor and or portion of the amount allowable as a carryover of deductible expenses for Income Tax purposes under the Taxes and Duties Act from the commencement of the Timor Gap Treaty and through the transition to the Timor Sea Treaty.

The Commissioner is bound by this ruling as stipulated in section 66 of UNTAET Reg. 2000/18, until withdrawn and or amended

• **Background**

Chapter VI of the Timor-Leste Petroleum Taxation Act 2005 (PTA) imposed Supplemental Petroleum Tax (SPT) on certain taxpayers conducting petroleum operations within a defined area. Article 26 (1) of the PTA stipulated the commencement date for the application to be the tax year commencing on or after January 2005 and therefore the provisions of the PTA were not intended by the Timor-Leste parliament to be applied retroactively to tax years preceding the commencement date.

Chapter IX of the Taxes and Duties contains the substantive provisions of law regulating the computation of income tax for Contractors and Subcontractors of petroleum operations in both Timor-Leste exclusive area and certain non-Annex Joint Production Development Area (JPDA).

The PTA was repealed through and by the Taxes and Duties Act 2008 (TDA) Law No. 8, which

4

became effective for the tax year commencing from 1 January 2008. The provisions of the PTA were reincorporated into Chapter IX of the Taxes and Duties Act 2008.

Effectively, the Supplemental Petroleum Tax is applicable in Timor-Leste for tax year commencing from January 1 2005.

The legal basis for the imposition of the SPT for the 2005-2007 tax years is the PTA and the TDA for tax years commencing from January 1, 2008.

Article 23(1) (Transitional provisions), Annex G of the Timor Sea Treaty (TST) preserves the business losses incurred in the JPDA by a person in a year previous to the year in which the Taxation Code enters into force. Such qualifying business losses presumably arose pursuant to the Timor Gap Treaty (TGT) and which was applicable in the area designated as the Zone of Cooperation Agreement between Indonesia and Australia. The treaty was signed on December 11, 1989 and came into force on February 9, 1991. It governed the joint exploitation of petroleum resources in a part of the Timor Sea seabed claimed jointly by Australia and Indonesia. The TST replaced the TGT effective from 20 May, 2002.

The Exchange Notes and Memorandum of Understanding dated February 10, 2001 and made between Australia and the United Nations Transition Administration preserved the application of TGT during the transition period in East Timor.

East Timor and Australia entered into a separate agreement through an Exchange of Notes dated May 20, 2002 to govern the exploration and exploitation of petroleum resources in the JPDA until the ratification of the TST by the two signatory governments. The Exchange Notes provided for the continuation of the exploration and exploitation arrangements that were in force on May 19, 2002.¹ It was further provided that upon the TST acquiring the force of law, the provisions shall be deemed to take effect from May 20, 2002 including the 90:10 apportionment factor in favor of East Timor². The Zone of Cooperation under the TGT was deemed abandoned and replaced with the JPDA (covering the area previously designated as "A" under the TGT).

- **Law and Analysis**

The substantive provisions in the PTA regarding the imposition of SPT, tax rate and calculation of SPT are outlined in Article 17-23 of the PTA as follows:

Article 17

Imposition of Supplemental Petroleum Tax

17.1 A Contractor that has a positive amount of accumulated net receipts for Petroleum Operations for a tax year is liable to pay Supplemental Petroleum Tax for that year.

¹ Exchange Notes 2002, Article 3.

² Exchange Notes 2002, Articles 4(a) & 5.

17.2 The Supplemental Petroleum Tax payable by a Contractor for a tax year is calculated according to the following formula:

$$A \times 22.5\% / (1-r)$$

where:

A is the accumulated net receipts of the Contractor for Petroleum Operations for the year; and
r is the corporate rate of tax as specified in Article 6.

17.3 Supplemental Petroleum Tax imposed under this Article on a Contractor for a tax year is in addition to the income tax imposed on the taxable income of the Contractor for the year.

17.4 Supplemental Petroleum Tax paid by a Contractor is deductible in calculating the taxable income of the Contractor in the tax year in which the tax was paid.

Article 18

Accumulated Net Receipts

18.1 The accumulated net receipts of a Contractor for Petroleum Operations for a tax year is calculated according to the following formula:

$$((A \times 116.5\%) - (I \times (1-r))) + B$$

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;

I 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 in the formula as a negative number); and

r is the corporate rate of tax as specified in Article 6.

18.2 If Supplemental Petroleum Tax is payable by a Contractor for a tax year, the amount of the accumulated net receipts of the Contractor for Petroleum Operations at the end of that year is zero for the purposes of calculating the accumulated net receipts of the Contractor for the Petroleum Operations for the next year.

18.3 If component $(A \times 116.5\%)$ of the formula in Section 18.1 is negative for a tax year, the subtraction of component $(I \times (1-r))$ for that year does not reduce the amount of $((A \times 116.5\%) - (I \times (1-r)))$ to an amount that is less than A. The amount of any excess is not carried forward or carried back to any tax year.

Article 19

Net Receipts

The net receipts of a Contractor for Petroleum Operations 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 the year. The net receipts of a Contractor for a tax year may be a negative amount.

Article 20

Gross Receipts

20.1 The gross receipts of a Contractor for Petroleum Operations for a tax year is the sum of the following amounts:

(a) The gross income for income tax purposes accrued by the Contractor in the year from Petroleum Operations, including amounts received from the hiring or leasing out of, or the granting of rights to use property, but not including interest income;

(b) The consideration received by the Contractor in the year for the disposal, destruction, or loss of any property (including materials, equipment, plant, facilities, and intellectual property or rights) used in Petroleum Operations if the expenditure incurred in acquiring the property was deducted in computing the net receipts of the Contractor for any tax year;

(c) Any amount received by the Contractor in the year from the provision of information or data obtained from any survey, appraisal, or study relating to Petroleum Operations if the expenditure incurred in undertaking the survey, appraisal, or study was previously deducted in computing the net receipts of the Contractor for any tax year;

(d) Any other amount received by the Contractor in the year that is a reimbursement, refund, or other recoupment of an amount previously deducted in computing the net receipts of the Contractor for any tax year; and

(e) If property used in Petroleum Operations has been destroyed or lost by a Contractor, any compensation, indemnity, or damages received by the Contractor in respect of the property under an insurance policy, indemnity agreement, settlement, or judicial decision.

20.2 Notwithstanding Section 20.1, and subject to Article 22, the gross receipts of a Contractor do not include any amount received or accrued as consideration for the transfer of an interest in Petroleum Operations.

20.3 If an amount referred to in Section 20.1 is attributable to Petroleum Operations and some other activity of the Contractor, only that portion that relates to the Petroleum Operations is included in the gross receipts of the Contractor in calculating the net receipts of the Petroleum Operations.

Article 21

Deductible Expenditure

21.1 Subject to Section 21.2, the total deductible expenditure of a Contractor for Petroleum Operations for a tax year is the sum of the following amounts:

(a) Any expenditure incurred by the Contractor in the year in respect of the Petroleum Operations and deductible (other than as a depreciation deduction) in computing taxable income, including interest and financing charges;

(b) Any capital expenditure incurred by the Contractor in the year in acquiring or constructing a tangible or intangible asset for use in Petroleum Operations;

(c) Any exploration expenditure incurred by the Contractor in the year in respect of Petroleum Operations; and

(d) An amount of Timor-Leste corporate income tax of the Contractor for the year calculated by applying the corporate rate of tax as specified in Article 6 to the taxable income of the Contractor for the year before deduction of Supplemental Petroleum Tax.

21.2 Notwithstanding Section 21.1, and subject to Article 22, the deductible expenditure of a Contractor does not include any amount incurred as consideration for the acquisition of an interest in Petroleum Operations.

21.3 If an amount referred to in Section 21.1 is attributable to Petroleum Operations and to some other activity of the Contractor, only that portion that relates to the Petroleum Operations is deductible expenditure of the Contractor in computing the net receipts of the Petroleum Operations.

Article 22

Transfer of Interest in Petroleum Operations

22.1 If the whole of a Contractor's interest in Petroleum Operations is transferred to another Contractor, the transferee Contractor is treated as having the same gross receipts and deductible expenditures in respect of the interest as the transferor Contractor had immediately before the transfer. For the purposes of calculating the transferee Contractor's accumulated net receipts for the tax year in which the transfer occurred, the transferor Contractor's accumulated net receipts at the end of the previous tax year is treated as the transferee Contractor's accumulated net receipts for that previous year.

22.2 If part of a Contractor's interest in Petroleum Operations is transferred to another Contractor:

(a) The transferee Contractor is treated as having the gross receipts and deductible expenditures in respect of that partial interest as the transferor Contractor had in relation to the whole interest immediately before the transfer multiplied by the transferred percentage factor; and

(b) For the purposes of calculating the transferee Contractor's accumulated net receipts for the tax year in which the transfer occurred, the transferor Contractor's accumulated net receipts at the end of the previous tax year multiplied by the transferred percentage factor is treated as the transferee Contractor's accumulated net receipts for that previous tax year.

22.3 In this Article, "transferred percentage factor" means the transferor Contractor's percentage ownership of the Petroleum Operations that is transferred divided by the transferor Contractor's total percentage ownership in the Petroleum Operations prior to the transfer.

The computation of SPT liability of a taxpayer is based on the Accrued Net Receipts (ANR) as stipulated in Article 18 of the PTA. Among other factors, ANR of a particular tax year is to be calculated based on the carried forward balance (if any) of ANR for previous years and current year's net receipts. Pursuant to Article 18 of the PTA, previous year's balance of ANR is entitled to 16.5% uplift and then added with the current year's net receipts for the purpose of calculating the current year's ANR.

All the Contractors (including joint venture partners) of a valid Production Sharing Contracts

(PSCs) in existence (other than Annex F area) on 1 January 2005 became subject to the SPT regime that was instituted pursuant to Article 17(1) of the PTA. Among the PSCs in existence on 1 January 2005, JPDA 03-01 PSC of April 2, 2003 was preserved through JPDA 06-105 PSC, dated 24 July 2006. JPDA 03-01 PSC of April 2, 2003 which preceded JPDA 06-105 is deemed to have come into effect from 20 May 2002. As stipulated in the contract, all the terms and conditions outlined in the predecessor PSC 91-01 continued to be applicable to JPDA 03-01 PSC. JPDA 03-01 PSC was subsequently replaced by the JPDA 06-105 PSC dated 24 July 2006.

- **Deductibility of pre-2005 costs incurred by the taxpayers under 91-01 PSC and 03-01 PSC**

A question of interpretation has been raised by a number of taxpayers and other interested parties in relation to the pre-2005 costs incurred by the taxpayers under the 91-01 PSC and 03-01 PSC. The central issue is whether such pre-2005 costs are deductible under Article 18 of the PTA for the purpose of the SPT calculation.

The amount of the Accumulated Net Receipts (ANR) on which SPT is calculated by using the rate/method prescribed in Article 17 of the PTA, is obtained by the following the formula prescribed in Article 18 of PTA:

$$((A \times 116.5\%) - (I \times (1-r))) + B$$

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;

I 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 in the formula as a negative number); and

r is the corporate rate of tax as specified in Article 6.

What should be the ANR at the end of the previous (2004) tax year. Since A "is the Contractor's accumulated net receipts for Petroleum Operations at the end of the previous tax year?" Should all of the pre-2004 costs and revenue be carried forward and be included in the calculation of 2004 ANR, or only the cost incurred and revenue earned in 2004 be allowed for such calculation?

NDPR's interpretation of Article 18 of the PTA is that **all** costs incurred and revenue earned by the taxpayers before 1 January 2005 under 91-01 and 03-01 PSCs should be accumulated, carried forward and be allowed as 2004 Accumulated Net Receipts under Article 18 of the PTA for purpose of calculating the 2005 SPT.

- **Effect of the Timor Sea Treaty Framework/Reduction Percentage in respect of deductibility of cost incurred before 20 May 2002**

The TST between Timor-Leste and Australia became effective in Timor-Leste from 20 May 2002³. The TST prescribes 90% taxing right to Timor-Leste and 10% taxing right to Australia on all petroleum operations within the Joint Petroleum Development Area (JPDA)⁴. Prior to May 20 2002 the governing law between Australia and Indonesia for the allocation of income and loss in respect of the Production Sharing Contract (PSC) that preceded PSC 06-105 was the Timor Gap Treaty (TGT).

The TGT was a provisional agreement for the resources a joint development of petroleum resources in the Timor Gap.⁵ The TGT stipulates a Zone of Cooperation Area (ZOCA) covering three (3) partitioned areas and which was marked as "A", "B" and "C." The TGT contains the substantive provisions applicable in ZOCA and four (4) annexes, namely, the maps and the coordinates, Mining Code for Area A, Model Production Sharing Contract (MPSC) and the Taxation Code.

Area A was subject on the TGT to the joint control of Australia and Indonesia for the specific purposes of exploration and exploitation of petroleum resources on an equal sharing basis⁶.

Following the specific provision of Article 4 of the Taxation Code of the TGT, the taxing right (business profits or losses) between Indonesia and Australia was stipulated at 50:50 in the same area known as Zone of Cooperation Area (ZOCA). Costs incurred by the JPDA 06-105 taxpayers or the predecessors and or under PSCs 03-01 and 91-01 before 20 May 2002 were governed by the said provisions of Article 4 of the TGT.

The categories of taxes determinable under TGT for the two signatory countries were specified pursuant to Article 3(1) of the Taxation Code. In Indonesia, the taxes were:

(i) the income tax (Pajak-Penghasilan), including the tax on profits after income tax payable by a contractor, imposed under the law of the Republic of Indonesia, and its implementing regulations;

(ii) the value-added tax on goods and services and sales tax on luxury goods (Pajak Pertambahan Nilai atas Barang dan Jasa dan Pajak Penjualan atas Barang Mewah) imposed under the law of the Republic of Indonesia, and its implementing regulations.

Article 3(2) of the Taxation Code to the TGT provides:

"The provisions of this Taxation Code shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of this Treaty in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective taxation laws within a reasonable period of time after such changes."

There is a question in relation to the percentage of pre-20 May 2002 cost that may be lawfully carried forward and deductible for 2005 SPT calculation purpose. Pursuant to Article 23(1) and

³ Law No. 5/2002, dated September 10, 2002.

⁴ Article 4, TST; Article 1(e), Taxation Code (Annex G) of the TST.

⁵ White, M.W.D., *Marine Pollution Laws of the Australian Region*, Federation Press, Sydney, 1994 at 129

⁶ Article 2(4)

(2) of Annex G to the TST, the position of NDPR is that only 50% of the costs incurred by the taxpayers and which costs were incurred pursuant to the provisions of TGT and before the commencement date (May 20, 2002) of the TST are eligible to be carried over and deductible both for income tax and SPT purposes.

The fiscal regime and the scheme of taxes are embodied in Article 5 of the TST and which provides:

(a) Unless a fiscal scheme is otherwise provided for in this Treaty:

- i. East Timor and Australia shall make every possible effort to agree on a joint fiscal scheme for each petroleum project in the JPDA.
- ii. If East Timor and Australia fail to reach agreement on a joint fiscal scheme referred to in sub-paragraph (i), they shall jointly appoint an independent expert to recommend an appropriate joint fiscal scheme to apply to the petroleum project concerned.
- iii. If either East Timor or Australia does not agree to the joint fiscal scheme recommended by the independent expert, East Timor and Australia may each separately impose their own fiscal scheme on their proportion of the production of the project as calculated in accordance with the formula contained in Article 4 of this Treaty.
- iv. If East Timor and Australia agree on a joint fiscal scheme pursuant to this Article, neither Australia nor East Timor may during the life of the project vary that scheme except by mutual agreement between East Timor and Australia.

b) Consistent with the formula contained in Article 4 of this Treaty, East Timor and Australia may, in accordance with their respective laws and the taxation code, impose taxes on their share of the revenue from petroleum activities in the JPDA and relating to activities referred to in Article 13 of this Treaty.

Article 4 of the TST provides:

Sharing of petroleum production

(a) East Timor and Australia shall have title to all petroleum produced in the JPDA.

Of the petroleum produced in the JPDA, ninety (90) percent shall belong to East Timor and ten (10) percent shall belong to Australia.

(b) To the extent that fees referred to in Article 6(b)(vi) and other income are inadequate to cover the expenditure of the Designated Authority in relation to this Treaty, that expenditure shall be borne in the same proportion as set out in paragraph (a).

Article 23(1) of Annex G of the TST provides:

"Business losses incurred in the JPDA by a person in a year previous to the year in which this Taxation Code enters into force and business losses apportionable in accordance with paragraph 2 to that part of the year prior to the date that this Taxation Code enters into domestic law effect,

may, for the purposes of the taxation law of a Contracting State and in accordance with the provisions of that law, be carried forward for deduction against income which is subject to the provisions of this Taxation Code, in accordance with the provisions of this Taxation Code.”

By the force of the language and the specific provision of Article 23(1) of the TST, there are two statutory “buckets” of business losses that could be incurred in the JPDA as envisioned by Article 23(1), namely:

1. those incurred by a person in a year previous to the year in which the Taxation Code (Annex G to the TST) enters into force; and
2. those business losses apportionable in accordance with paragraph 2 of Article 23.

If the framers of Article 23 had intended an automatic expansion of business losses from 50% under TGT to 90% under the TST there would have been no need for the separation of the business losses contemplated by Article 23(1) into two (2) buckets. Article 23 (1) of Annex G to the TST does not provide a platform to any taxpayer for benefits over and beyond the quantum and scope of those benefits as they existed on May 19, 2002, and which business losses arose under the predecessor Treaty. The business losses over which any taxpayer subject to SPT and income tax in the non-Annex F JPDA could make a legitimate claim in Timor-Leste as carryover deductible costs are limited to what existed prior to the effective date of the TST, as computed under the predecessor Treaty i.e. TGT.

Article 23 of Annex G to the TST simply preserves the quantum of the business losses available to a taxpayer and which existed as at May 19, 2002 under Article 4 of the Taxation Code to the TGT and does not confer any additional benefit beyond that. NDPR does not accept Article 23(1) as the statutory authority as claimed by certain taxpayers to increase the business losses from 50% as apportioned under the TGT to 90% before the effective date of the TST. As indicated above, Article 23 (Annex G) of the TST merely preserves what was available to the taxpayer in terms of business losses as at May 19, 2002 under Articles 3 and 4 of the Taxation Code of the TGT and certainly not an authority to widen it from 50% to 90% for the purposes of the ANR in Timor-Leste, and certainly also for the purpose of computing the income tax payable by a Contractor in Timor-Leste.

For the purposes of income tax and SPT in Timor-Leste, the quantum of the business income losses subject to the taxing jurisdiction of both Australia and Indonesia available to any qualifying taxpayer prior to May 20 2002 and which may be carried over to 20 May, 2002 is limited to 50% as stipulated under Articles 3 and 4 of the Taxation Code of the TGT. Pursuant to Article 5(b)(ii), the 50% apportionment stipulated under Article 4 of the Taxation Code of the TGT is applicable for the purposes of both income tax and also the tax on profits after the income tax payable by a contractor.

Furthermore, Article 23 (2) of Annex G to the TST provides in pertinent term as follows:

“In the year in which this Taxation Code enters into force the Contracting States shall only apply the framework percentage or reduction percentage to that proportion of income, losses and other

items addressed by this Taxation code which corresponds to that portion of the period from the date of entry into domestic law effect to the end of the year (emphasis provided). "

The test of Article 23(2) as applicable to the framework percentage or reduction percentage is in two parts, namely:

1. portion of the period of the period corresponding from the date of entry of the TST domestic law effect to the end of the year; and
2. the period preceding the coming into effect of the TST.

The first leg of the test, being the period from the commencement date, is subject to the 90:10 framework percentage or reduction percentage stipulated in Article 5 of the TST. The other leg of the test is subject to the framework percentage or reduction percentage under Article 4 of the TGT at 50%.

Based on the unambiguous provision of Article 23 of Annex G to the TST and Articles 3 and 4 of the TGT, the position of NDPR is that the apportionment of items of income, losses and similar items addressed by the Taxation Code and common to both Australia and Timor-Leste are separable into two (2) categories/regimes, namely:

1. The period under TGP: 50:50 apportionment factor; and
2. The period under TST: 90:10 apportionment factor

Article 23(2) of Annex G to the TST is a legal barrier preventing the increase of the quantum of income, losses and other items addressed in the Taxation Code apportionable to a taxpayer under TGT; and which is allowed as a carryover under Article 23(1) of Annex G to the TST. Under the most munificent interpretation, Article 23 of Annex G to the TST cannot provide a statutory foundation for the escalation of the business losses, and which were incurred under the TGT and carried over under the TST.

Article 23 must also be read along with the Exchange Notes dated February 10, 2001 and made between UNTAET and Australia. Paragraph 3 of the said Exchange Notes provides:

"UNTAET therefore has the honour to advise the Australian Mission in East Timor that all rights and obligations under the Timor Gap Treaty previously exercised by Indonesia are assumed by UNTAET, acting on behalf of East Timor, until the date of independence of East Timor. UNTAET, acting on behalf of East Timor, and Australia may enter into subsidiary arrangements or agreements relating to the continued operation of the terms of the Treaty. In agreeing to continue the arrangements under the terms of the Treaty, the United Nations does not thereby recognize the validity of the "integration" of East Timor into Indonesia."

To prevent any legal vacuum pending the ratification of the TST by each signatory government, Australia and East Timor entered into another agreement by way of Exchange of Notes on May 20, 2002 to govern the exploration and exploitation of petroleum resources in the JPDA. Article

3 of the Exchange of Notes provides for the continuation of the exploration and exploitation arrangements in force on May 19 2002.

Finally, a taxpayer has argued that the implicit repeal of the TGT by the TST and the recognition of the TST in the Revenue System Amendment Act (RSAA), 2002 (Law No.5) and lack of mention of the TGT in the RSAA meant that the TGT is inapplicable to SPT. Article 26.1 of the Petroleum PTA provides that the Act applies only to tax years commencing on or after January 1, 2005. No distinction was made between the sum incurred under the TGT regime and or under any law that preceded the TST. The TST did not invalidate business losses incurred under previous law and prior tax years. The law governing the apportionment of income and expenditure between Australia and Indonesia before the passage of the TST was the TGT. The business losses existing as at May 19, 2002 arose under the TGT. Similar to the items of expenditure deductible for income tax purposes, part of the costs deductible for SPT and income tax purposes were incurred under the TGT. The revocation of the TGT and the replacement with the TST does not mean an automatic change to the tax benefits under TGT.

Since the concept of ANR under Article 18 of the PTA is the basis for the computation of the SPT liability, NDPR does not accept the logic that the non-inclusion of TGT as part of the RSSA meant that TGT cannot be applied to the SPT. If any portion of the deductible expenditure of a taxpayer for SPT purposes arose prior to the commencement date of the TST, then the quantum of such expenditure deductible for SPT in Timor-Leste is determinable under TGT. In any case, it would have been superfluous to mention the TGT in the RSSA at that time because the TST was deemed to have effectively replaced the TGT and the Memorandum of Understanding dated 10 February, 2000 that TST replaced.

Furthermore, the taxpayer's argument about the legality and applicability of the TGT in Timor-Leste is inconsistent with the facts and the law. After the withdrawal of Indonesia from East Timor in 1999, the Security Council on 25 October 1999 established the United Nations Transition Administration in East Timor (UNTAET), through its 1272 Resolution, for an initial period of 16 months until 31 January 2001. This resolution empowered UNTAET to take "all necessary measures to fulfill its mandate" such as the "establishment of conditions for sustainable development" in East Timor. The TGT ceased to be in force when Indonesian Authority over East Timor was transferred to the United Nations.

The UNTAET had sufficient authority during the pendency of its mandate in East Timor to enter into agreements and or negotiations on behalf of East Timor before independence. The officials of East Timor recognized the need for legal certainty and enforcement of contracts for the ongoing petroleum activities in the ZOCA but the UNTAET and the Timorese officials were regarded the TGT as illegal and were unwilling to accept it as a lawful instrument.⁷ As opposed to the continued application of the TGT which was largely regarded as illegal in East Timor, on February 10, 2001 the UNTAET and Australia entered into an agreement to continue the terms of the TGT by way of Exchange Notes and a Memorandum of Understanding.

⁷ Campbell, B., *Maritime Boundary Arrangements in the Timor Sea* (2000) 1 *International Trade and Business Law*, 61 at 64

The Exchange of Notes of February 10, 2001 provides in pertinent terms:

"The United Nations Transitional Administration in East Timor (UNTAET) presents its compliments to the Australian Mission in East Timor and has the honour to refer to the fact that, pursuant to United Nations Security Council resolution 1272 (1999) of 25 October 1999, and in accordance with paragraph 35 of the Report of the Secretary-General (S/1999/1024), the United Nations will conclude such international agreements with States and international organizations as may be necessary for the carrying out of the functions of UNTAET in East Timor.

An agreement between UNTAET, acting on behalf of East Timor, and Australia, providing practical arrangements for the continuity of the terms of the "Treaty between Australia and the Republic of Indonesia on the Zone of Cooperation in an Area between the Indonesian Province of East Timor and Northern Australia" (the "Timor Gap Treaty") in the transitional period, will benefit the people of East Timor and will assist UNTAET in carrying out its functions entrusted to it under Security Council resolution 1272 (1999). The conclusion of this agreement, however, is without prejudice to the position of the future government of an independent East Timor with regard to the Treaty.

UNTAET therefore has the honour to advise the Australian Mission in East Timor that all rights and obligations under the Timor Gap Treaty previously exercised by Indonesia are assumed by UNTAET, acting on behalf of East Timor, until the date of independence of East Timor. UNTAET, acting on behalf of East Timor and Australia may enter into subsidiary arrangements or agreements relating to the continued operation of the terms of the Treaty. In agreeing to continue the arrangements under the terms of the Treaty, the United Nations does not thereby recognize the validity of the "integration" of East Timor into Indonesia.

If the understanding of Australia is in accordance with the foregoing advice, UNTAET has the honour to propose that this Note and Australia's confirmatory Note in reply shall constitute an agreement between UNTAET, acting on behalf of East Timor, and Australia which shall be applied as of 25 October 1999."

This agreement substituted Indonesia for East Timor in the TGT and also gave continuation to the terms of the Treaty until UNTAET fulfills its mandate. Negotiations between the interested parties, namely, Australia, UNTAET and the East Timor Transition Authority (ETTA) resulted into the endorsement of the "Timor Sea Arrangement" on July 5, 2002 and which outlined the framework for a treaty to cover the joint development of the Timor Sea resources. On May 2002, East Timor became a sovereign and independent country. The governments of Australia and East Timor signed the TST. As indicated earlier, to prevent any legal vacuum pending the ratification of the TST by each signatory government, Australia and East Timor entered into another agreement by way of Exchange of Notes on the same day the TST was signed to govern the exploration and exploitation of petroleum resources in the JPDA. Article 3 of the Exchange of Notes provides for the continuation of the exploration and exploitation arrangements in force on May 19 2002.

The TST became law in Timor-Leste on September 20, 2002 (date of publication) through the instrumentality of the Revenue System Amendment Act, Law No. 5/2002 but the TST took effect from May 20, 2002.⁸

The quantum of the deductible expenditure in Australia and Indonesia arising before the commencement of the TST, and in connection with ZOCA was determinable pursuant to Articles 3 and 4 of the Taxation Code to the TGT. Paragraph 3 of the Exchange of Notes preserves the continuation of the sharing formula in East Timor during the transition period. Article 3 of the Exchange Notes dated May 20, 2002 provides for the continuation of the exploration and exploitation arrangements in force on May 19, 2002. Effectively, the pertinent terms governing the exploration and exploitation of petroleum resources under the TGT survived until May 19, 2002. The TST subsequently became law on September 10, 2002 in Timor-Leste but the effective date was stated to be May 20, 2002. Article 23 of Annex G of the TST preserved the business losses that existed on May 19, 2002, and those were presumably the business losses incurred during the pendency of the TGT.

In the circumstances, it is therefore incorrect as one taxpayer did, to suggest that the implicit repeal of the TGT by the TST and the lack of mention of the TGT in the Revenue System Amendment Act (RSAA), 2002 (Law No.5) was fatal and meant that the TGT is inapplicable to SPT. That view is invalid and does not represent the applicable law in Timor-Leste.

- **Applicability of 16.5% uplift factor in the calculation of ANR under Article 18 of the PTA**

The formula as prescribed in Article 18 of the PTA provides the legal platform for a qualifying taxpayer to add 16.5% each year with the ANR carried forward from previous year. Is the annual uplift factor (16.5%) applicable for each tax year preceding the PTA, or limited to the amount accumulated as at January 1, 2005 tax year and thereafter? Substantive provisions of the PTA should not be applied retroactively and certainly not in a manner that will confer the benefits of the 16.5% uplift provided in Article 18 of the PTA to the tax years preceding the commencement date on individual tax year basis.

There is clarity in the law regarding the commencement date and the legislative intent is to apply the law prospectively as provided in Article 26(1) of the PTA.

Therefore, the 16.5% uplift factor as prescribed in Article 18 of the PTA is applicable only to the accumulated ANR available to a taxpayer on 1 January 2005 and subsequent tax years. The uplift is certainly not available for pre-2005 ANR on individual tax year basis and NDPR will not allow a look back application that is contrary to the unambiguous provision of the enabling law by allowing taxpayers to apply the 16.5% uplift individually to tax years preceding the enactment of the PTA instead of the accumulated net receipts as at December 31, 2004.

- **Simulated Scenario:**

⁸ Section 20(2), Revenue System Amendment Act, Law No. 5/2002.

XYZ Oil & Gas Captain Inc. is a Contractor/Operator of a PSC agreement currently conducting petroleum operations in the JPDA (non-Annex F). The PSC Contractor/Operator has two other joint venture partners in the PSC. The original PSC agreement between the Contractors (operator and joint venture partners) and the Designated Authority was made in 1991. After the independence of Timor-Leste and the passage of the Timor Sea Treaty between Australia and Timor-Leste, a new successor PSC to the 1991 PSC was signed in 2003, and became effective from 20 May 2002. The 2003 PSC was replaced yet by another in 2006 but with fairly similar material terms and conditions.

How should the expenses incurred by the taxpayers (Contract Operator and joint venture partners), during 1991-2004 tax years be treated for Timor-Leste income tax and SPT purposes? For the purpose of calculating the ANR under Section 18 of the PTA, the net receipt is to be computed pursuant to Article 19 of the PTA, for each of the 1991-2004 years separately. However, the formula $((A \times 116.5\%) - (I \times (1-r))) + B$ as stipulated in Article 18 of the PTA should not be applied to the ANR for 1991-2004 individual tax years (compounded) but to the balance (cumulative) as at December 31, 2004. Thereafter, the 16.5% uplift will continue to apply on a yearly basis to the ANR balance (if any) from 2005 tax year until the expiration of the PSC.

Pursuant to predecessor Treaty to the TST (TGT) and more particularly Articles 3 and 4 of the Taxation Code of the TGT, only 50% of the expenses and revenue for 1991-2001 years should be carried forward for Timor-Leste income tax and SPT purposes. Revenue and expenses should be separated for pre-20 May 2002 and post 20 May 2002 periods. Only 50% of pre-20 May 2002 expense and revenue can be carried forward for Timor-Leste income tax and SPT purposes.

Pursuant to the TST, the 90:10 apportionment factor between Timor-Leste and Australia respectively is applicable only to post-20 May 2002 expense and revenue and the carryforward ratio should follow that apportionment factor for Timor-Leste income tax and SPT purposes.

Furthermore, Article 25 of the Taxation Code (Annex G of the TST) provides:

Entry into force -

"This Taxation Code shall enter into force at the same time as the Treaty to which it forms part." The Taxation Code is an annexure to the TST and the law is clear to the effect that the Taxation Code is effective only from the date the TST enters into force. Since the TST entered into force on May 20 2002, the benefits and the burden under the TST, including the Taxation Code annexed to the TST, commenced from the same date.

It has also been suggested by a taxpayer during the period that NDPR solicited interested parties to comment on the draft ruling that if only 50% of the business losses of the pre-20 May, 2002 were available to a taxpayer as proposed by NDPR, as opposed to the 90% suggested by a taxpayer, then only 50% of the post May 19, 2002 income should be subject to both income tax and SPT in Timor-Leste until the full recovery of the pre-20 May, 2002 business losses. NDPR rejects such a proposal as lacking in statutory support and without merit.

There is no provision in any of the revenue laws applicable to a Petroleum Contractor in Timor-Leste permitting such a proposal. It is trite law that tax deductions and or tax benefits are strictly matters of legislative grace and it is incumbent on any taxpayer making a claim for either a tax deduction and or benefit to anchor such claims on a specific provision of the law. Section 144(2) of the Constitution of the Republic of Timor-Leste provides: Taxes shall be

established by law, which shall determine obligation, tax benefits and the guarantees of taxpayers.”

It will amount to a rewrite of the law if NDPR accepts the proposal to limit the income subject to both income tax and SPT to 50% of the post May 19, 2002 revenue until the full recovery of the pre-20 May 2002 business losses.

Pursuant to section 95 of the Constitution of the Republic, the Timor-Leste parliament is the only organ of government constitutionally endowed to exercise the power to make and or amend revenue laws and or tax policy. NDPR cannot unilaterally confer a tax benefit on a taxpayer beyond the scope set by the revenue laws.

- **Applicability of linear reduction of Interim PSC Cost for income tax and SPT purpose as prescribed in Article 6.5 of the JPDA 06-105 PSC**

Article 6.5 of the JPDA 06-105 PSC prescribes that a daily linear reduction of 1/3rd in a year, effective from the date of offer till the date of commercial discovery, would be deducted from the recoverable cost, if commercial discovery is not declared prior to 30 September 2006. The JPDA 06-105 PSC offer date was 24 May 2006 and declaration of commercial discovery of KITAN field was 11 April 2008. Therefore, pursuant to Article 6.5 of the JPDA 06-105 PSC about 2/3rd of the interim PSC cost eligible for cost recovery under 03-01 PSC has become unrecoverable for PSC purpose.

NDPR's position is that such linear reduction on recoverable past cost should not be applicable for income tax and SPT purposes and that the reduction is limited only for PSC purposes.

This Public Revenue is effective from June 29th, 2011. It is applicable to the tax years under the TGI, including the tax years subject to the Exchange Notes dated February 10, 2001 between Australia and UNTAET, the Exchange Notes and the Memorandum of Understanding dated May 20 2002, and made between Australia, UNTAET and the East Timor Transition Authority. The Public Ruling is also applicable to any tax assets or liabilities carried over into and subject to the Timor Sea Treaty, Petroleum Taxation Act and Chapter IX of the Taxes and Duties Act.

Taxpayers who may have adopted contradictory tax positions on matters of income tax and SPT specifically discussed in this Public Ruling in any of their previous tax filings with the Timor-Leste tax administration may amend such tax filings without any sanctions on or before August 31, 2011.

The Principal author of this Public Ruling is Mr. B.W. Boye Esq., Petroleum Tax Law Adviser, NDPR.



Câncio de Jesus Oliveira
Commissioner & Director General
Directorate of Revenue & Customs

Dated this 28th day of June, 2011



REPÚBLICA DEMOCRÁTICA DE TIMOR LESTE
MINISTÉRIO DAS FINANÇAS
DIRECÇÃO GERAL DE RECEITAS E ALFÂNDEGAS
DIRECÇÃO NACIONAL RECEITAS PETROLIFERAS



Alexus Conflicto Bemvinda Desenvolvimento

National Directorate of Petroleum Revenue

Public Ruling: Withholding Tax: Section 81 of the Taxes and Duties Act, No. 8/2008

Public Ruling 2010-81

Relying on this Ruling

This is a public ruling within the meaning of section 66 of Regulation 2000/18. Information in this ruling may be relied upon by taxpayers as the basis for determining their tax liability.

Criteria or tests to be met in determining whether a payment was made by a Contractor or Subcontractor as compensation arising out of Timor-Leste source services (other than as an employee) acquired for Petroleum Operations and therefore subject to the withholding tax regime of section 81 of the Taxes and Duties Act, No.8/2008.

Advice has been requested concerning the criteria or tests to be met in determining when a payment made by a Contractor or Subcontractor as compensation for Timor-Leste source services is made pursuant for services acquired for Petroleum Operations.

This Public Ruling is intended to address the ambit of section 81 of the Taxes and Duties Act.

LAW AND ANALYSIS

Section 81 of the Taxes and Duties Act provides, in part, as follows

81.1. A contractor or Subcontractor paying an amount of Timor-Leste source services income to a person (other than as an employee) for services acquired for Petroleum Operations shall withhold tax from the payment at the rate of 6% of the gross paid.

81.2. Services income is Timor-Leste source services income if the income is paid by a resident person or a Timor-Leste permanent establishment of a non-resident person.

81.3. If a lump sum is paid for services and goods, the amount shall be treated as paid for services to the extent that the Tax Administration considers reasonable having regard to all the circumstances.

81.4. If an amount described in Section 81-1 has been correctly subject to withholding tax under this Section, the tax withheld is a final tax on the income of the recipient represented by the payment and:

- (a) No further income tax liability is imposed on upon the recipient in respect of the gross income to which the tax relates;
- (b) That gross income is not aggregated with the other gross income of the recipient for the purposes of ascertaining the recipient's taxable income;
- (d) There is no deduction, including depreciation or amortisation deduction, for any expenditure or loss incurred in earning the gross income.

Following the omnibus language of Section 81.1, the only ground upon which a payment made by a Contractor or Subcontractor as compensation arising out of Timor-Leste source services (other than as an employee) may be exempt from the withholding tax regime of Section 81.1 is where such payment was made for services not acquired primarily for Petroleum Operations. The determination of the type of payment subject to the withholding tax of Section 81 is made from the perspective of the company acquiring the services. The nature of the business of the service provider is irrelevant where the service in question is acquired for petroleum operation. In any case, it is unlikely that a Contractor and Subcontractor will procure services in furtherance of their core business from a non-petroleum service provider.

Support services such as accounting, legal and other similar services procured for the purposes of fulfilling statutory obligation of the Contractors and Subcontractors to any governmental agency or any other regulatory body are considered to be in furtherance of core business.

In order for a payment made by a Contractor or Subcontractor as compensation arising out of Timor-Leste source services to be exempt from the withholding tax regime of section 81.1, the beneficiary or the payer must, among other things, show that it meets any or all of the following specific requirements:

- 1. that the payment is not an income under any applicable Timor-Leste taxation laws and or
- 2. that the Timor-Leste sourced services were not **acquired** for Petroleum Operations.

The term "Petroleum Operations" is defined in Chapter IX, section 68 of the Taxes and Duties Act to mean "authorised activities under a Petroleum Agreement." Petroleum Agreement is defined pursuant to section 68 to mean:

- a) A contract, license, permit, or other authorization 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 under the Code.

Article 1 (definitions) of the Petroleum Act defines "Petroleum Operations" to mean activities for the purposes of:

- i. prospecting for Petroleum;
- ii. exploration for, development, exploitation, sale or export of Petroleum, or
- iii. construction, installation or operation of any structures, facilities or installations for the development, exploitation and export of Petroleum, or decommissioning or removal of any structure, facility or installation.

Section 1.1 of the Petroleum Mining Code for the Joint Petroleum Development Area (JPDA) defines the term "Petroleum Operations" to mean any activity authorised by the Designated Authority, and includes:

- a. the exploration for, development and exploitation of Petroleum in the Contract Area, and the export of that Petroleum from the Contract Area;
- b. the construction, installation and operation of structures, facilities, installations, equipment and other property, and the carrying out of other works, necessary for the purposes mentioned in paragraph (a) above;
- c. Decommissioning, including removal of items referred to in paragraph (b) above;
- d. the marketing of that Petroleum; and
- e. planning and preparation for the activities mentioned in paragraphs (a), (b), (c) and (d) above.

The definition of the term "Petroleum Operations" as contained in Section 1 of the Model Production Sharing Contract (PSC) is exactly the same as the definition of the term contained in the Petroleum Mining Code.

By its definition, the ambit of the term "Petroleum Operations" as contained in the Taxes and Duties Act, the Petroleum Act, Petroleum Mining Code and the Model PSC is fairly broad. It covers literally all activities permissible to an oil and gas enterprise and which are primarily connected to petroleum operations.

In enacting Section 81, the Timor-Leste Parliament was concerned with situations in which taxpayers (especially non resident) performing services for Contractors and or Subcontractors involved with Petroleum Operations might receive income without reporting same and making the tax payments due from such income. That also is the rationale for making the withheld tax as a "final" tax on the gross income of the recipient as contained in section 81.4 of the Taxes and Duties Act.

In addition, the Parliament was also concerned with situations in which the persons performing services for and receiving payments from a Contractor and or Subcontractor may take a tax

position that the services were not performed for the purposes of Petroleum Operations and therefore not subject to the withholding tax regime of Section 81.

The Parliament in its wisdom was of the view that the type of payment subjected to the withholding tax regime of Section 81 is better defined from the perspective of the Contractors and subcontractors requesting such services rather than allowing the recipient to make such determination, and thereby create an opportunity for tax avoidance.

The legislative solution was to guard against the possibility of such tax manipulation by subjecting all payments (other than as an employee) made by Contractors and Subcontractors to service providers to the withholding tax regime of section 81, insofar as the acquirer of the services for which the payment was made is connected with Petroleum Operations as defined by law.

The scope of Section 81 thus extends to virtually every service that a Contractor and or Subcontractor involved with any Petroleum Operation may require in running the core business, and which services are sourced within Timor-Leste. For the purposes of section 81 withholding tax regime and for practical reasons, the core business of a Contractor or Subcontractor is interpreted by the National Directorate of Petroleum Revenue (NDPR) to mean only the services acquired in furtherance of any permissible business under the petroleum agreement applicable to the Contractor and Subcontractor making the payment.

Payment 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.

The list of services covered by section 81 includes (so long as they are connected with the core business and not tangential) 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)
- v) Courier services

For the purposes of Section 81 of the Taxes and Duties Act, 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:
 - the re-plugging of empty formation and zone producing water
 - rectification of a failed or damaged primary cementing; and
 - the sealing/closing off of the well.
- c. 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;
- d. matrix acidizing services, which are activities to increase the productivity by way of eliminating the unwanted blockage material;
- e. 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 small perforating power;
- f. 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;
- g. drill stem testing services, temporary completion of a new well, in order to evaluate the production capacity;
- h. pump services;
- i. installation and maintenance services;
- j. replacement services of equipment/material;
- k. mud logging services;
- l. stimulation and secondary recovery services;
- m. well logging services and perforating services;
- n. stimulation and secondary recovery services;
- o. well testing and wire line services;
- p. services in regard to off-shore navigational equipment which is related to drilling;
- q. maintenance services for the drilling activities;
- r. mobilization services and demobilization of drilling extension; and
- s. other similar services in the field of drilling oil and gas

With respect to payments made by a Contractor or Subcontractor for services combined with goods and or reimbursable expenses and the determination of the value to be appropriated to the service portion of the transaction, Section 81.3 of the Taxes and Duties Act requires the Tax

Administration of Timor Leste to “unbundle” the transaction in a reasonable manner, after considering all the circumstances.

When a single payment is made by a Contractor or Subcontractor for a bundled transaction, only the portion allocated to pure services as opposed to payment for goods and or reimbursable expenses is subject to the withholding tax regime of section 81 where:

- a. the various components are specified in the invoice presented to the Contractor or subcontractor; and
- b. such an arrangement is evidenced in the contract.

FACTS

Situation 1.

XYZ company enters into a personnel supply agreement with a Contractor. Pursuant to the terms of the said agreement, XYZ will receive reimbursement of the salaries paid to personnel supplied to the Contractor plus 10% markup. The contract further provides that XYZ is an independent contractor and that the persons furnished to the Contractor are regarded as employees of XYZ.

The monthly invoice from XYZ separates the reimbursement portion from the mark up fees.

Situation 2.

ABC, a service company, enters into a personnel supply agreement with a Subcontractor. ABC sends a monthly invoice to the Subcontractor without separating the cost from the mark up fees added to the salaries paid to the personnel supplied to the Subcontractor. The rates and the mark up fees are clearly stated in the contract.

The persons supplied by ABC to the Subcontractor are characterized as independent contractors under the contract between ABC and the affected persons.

Situation 3.

Tamara Power Company sold an electric generator to a Contractor under a lease - purchase agreement. The agreement also included a maintenance plan. The monthly payments including principal plus interest and maintenance fees are spread over a fixed period. Tamara Power Company issues a monthly invoice covering the principal plus interest charge and maintenance fees without separating one from the other.

Situation 4

Boston Engineering Services (BOSTON) was hired by a Contractor to plug an abandoned well. In the course of plugging the well in accordance with the terms of the contract, the Contractor added additional work outside the scope of the original contract but also connected with the plugging of the well. The Contractor enters into a separate contract to reimburse the expenses incurred by BOSTON for the additional work without any provision for a mark up.

BOSTON completed the additional work and presented its invoice as well as receipts from third parties (if any) without any mark up.

Situation 5

Rhapsody Petroleum Company (RPC) awarded a contract to FMK Engineering (FMK) for the manufacture, delivery and installation of subsea equipment at a fixed price. Progress billings and payments for the construction phase are done on a monthly basis. The billings for the delivery and installation would be done separately at end of the construction and upon delivery and installation.

In *Situation 1*, the entire invoice is subject to the withholding tax regime of section 81.1. The result would be different if the persons supplied by XYZ were also characterized as independent contractors of XYZ company. Depending on other factors such as the invoicing method, only the mark up portion may be subject to the withholding tax regime of section 81, if the persons supplied were indeed independent contractors of XYZ.

In *Situation 2*, the portion of the value of the invoice from ABC company to the Contractor appropriated to service and which is subject to the withholding tax regime of section 81.1 would be limited to the mark up portion.

In *Situation 3*, the portion of the value of the invoice from Tamara Power Company appropriated to service income would be determined by the *Tax Administration of Timor-Leste*.

Tamara Power Company will be required to file an income tax return to report the taxable income associated with the portion appropriated to sale of goods and interest income.

In *Situation 4*, the value of the entire invoice for the additional work is not subject to the withholding tax regime of section 81. It would not matter even if BOSTON had issued its own commercial invoice to cover all the charges and without a third party receipts/invoices.

On the other hand, the entire invoice for the additional work would be subject to withholding tax if the contractual arrangement between the Contractor and Boston had a provision for a mark up fee. Any labor charge in respect of the additional work by BOSTON would also be subject to the withholding tax regime.

In *Situation 5*, the monthly progress billings and payments would not be subject to withholding tax. FMK would be required to file income tax return during the manufacturing stage to report its taxable income from such payments.

On the other hand, if the contract provides for a fixed contract price payable upon installation of the equipment and FMK presented an invoice covering the manufacturing, delivery and installation, then section 81.3 would apply; so long as the manufacturing, delivery and installation are covered by the same contract. Same theory if FMK presented two or three separate invoices, as long as the manufacturing, delivery and installation are done pursuant to the same contract.

Section 81.4 relating to the finality of the taxes withheld as extinguishing the liability of the beneficiary is limited only to the value or payments received as consideration for services, and which was correctly subject to section 81 withholding tax regime.

If the beneficiary earned 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, such a person is not entitled to the benefits of section 81.4 and will be required to file an income tax return in Timor-Leste.

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.

For the purposes of the reporting obligation of the taxpayer receiving payments or a thing of value in exchange for something other than services, NDPR does not accept a distinction between Contractors and Subcontractors. Section 72 of the Taxes and Duties Act would be interpreted to include Contractors and Subcontractors in that respect.

Both Contractors and Subcontractors alike are required to file an income tax return in Timor-Leste to report such income.

The sourcing rules applicable to the Production Sharing Contracts in the Joint Production Development Area (JPDA) shall be as specified in the Timor Sea Treaty and may be supplemented (where necessary) with any applicable Indonesian Income Tax Laws relating to sources of income. Other Production Sharing Contracts outside of the JPDA shall be subject to the sourcing rules of the Taxes and Duties Act.

This Public Ruling will take effect from June 1, 2011 and will apply to obligations arising on or after this date.

DRAFTING INFORMATION

The principal author of this public ruling is B. W. Boye Esq., Petroleum Tax Law Adviser

REPÚBLICA DEMOCRÁTICA DE TIMOR-LESTE
MINISTÉRIO DAS FINANÇAS
COMISSÁRIO DOS SERVIÇOS DE RECEITAS

Câncio de Jesus Oliveira
Director General/Commissioner

Public Ruling 2011-11

Taxation of gains in connection with the Alienation of Property or Shares or comparable interest in a Company with asset (wholly or principally, directly or indirectly, including for example a chain of companies) within the Joint Production Development Area (JPDA)

National Directorate of Petroleum Revenue

Relying on this Ruling

This is a public ruling within the meaning of section 66 of Regulation 2000/18. Information in this ruling may be relied upon by taxpayers as the basis for determining their tax liability in respect of matters connected with the taxation of the proceeds arising from the sale of property, shares and or a comparable interest in a company with principal asset within the JPDA.

Advice has been requested by certain interested parties concerning the ambit/application of Article 11 of Annex G to the Timor Sea Treaty (TST) and the tax consequences attendant to the sale of property, shares and or comparable interest in a company with a presence in the JPDA.

This Public Ruling is intended to address the ambit of Article 11, Annex G to the TST and address the Timor-Leste tax consequences of transactions within the ambit of the said Article 11.

LAW AND ANALYSIS

The taxation of income from the JPDA (Annex F) is governed by:

- Timor Sea Treaty (including Annex G-Taxation Code);
- Directive 2001/2*
- Indonesian Income Tax Law (as at October 25,1999)
- UNTAET Reg. 2000/18

The taxation of income from the Non- Annex F part of the JPDA is governed by:

- Timor Sea Treaty (including Annex G-Taxation Code);
- Directive 2001/2*
- Petroleum Taxation Act¹
- The Taxes and Duties Act, Law No. 8/2008 (more particularly Chapter IX); and
- UNTAET Reg. 2000/18.

¹. *Parts of the laws were repealed and some parts reincorporated into the Taxes and Duties Act, Law No. 8, 2008.

Since the fiscal regime applicable to taxable Article 11 (Annex G, TST) transactions in Annex F portion of the JPDA is significantly different from that of the Non-Annex F part, the discussion relating to the taxability of Article 11 transactions within the JPDA is separated below for clarity.

Annex F, JPDA-Law & Analysis

Some taxpayers within Annex F of the JPDA have variously represented to the National Directorate of Petroleum Revenue (NDPR) that gains associated with the alienation of property, shares and or comparable interest in a company with principal asset in the JPDA are not subject to the regular petroleum taxation regime or alternatively that any gains from such transactions are subject only to the withholding tax regime of Article 26(2) of the Indonesian Law of Income Tax (1994).

Some taxpayers cited previous positions of the Timor Leste Revenue Services (TLRS) issued variously in 2001 indicating that indirect disposals or transfers of interests are not subject to tax in Timor-Leste. The TST (including Annex G) became law in Timor Leste only in May of 2002 and it is inconceivable that TLRS will issue an *Ex-ante* opinion on a law that was not in effect. Assuming such opinions were in fact rendered by the TLRS, such opinions are hereby are declared null and void and are no longer valid effective from May 20, 2002².

Furthermore, any interpretations or decisions of the TLRS relating to the issue of capital gains within the JPDA are not valid for the purposes of laws enacted or Treaties subsequent to such determinations and or decisions, and which are inconsistent with the subsequent laws and Treaties. Any such interpretations and or decisions are now repudiated and void.

Finally, some other taxpayers informed NDPR that Australian courts have found that such provisions like Article 11 of Annex G to the TST do not “impose” tax or create taxable income.

NDPR does not accept Australian courts’ decisions relating to taxation or any other matter as judicial authorities in Timor-Leste.

The decisions of Australian Courts are neither persuasive nor of any relevance in Timor-Leste. The governing tax laws in Australia are dissimilar from the Timor-Leste tax legislations. Timor-Leste is a sovereign nation and not a subdivision of another sovereign.

Furthermore, such an argument is at best frivolous in view of the unambiguous provision of Article 4(b) of the TST. The existing taxes to which the Taxation Code (Annex G) shall apply are: in East Timor:

- (i) The income tax, including either the tax on profits after income tax or the additional profits tax, as applicable to a specified petroleum project or part of a project;
- (ii) The value added tax and sales tax on luxury goods (“value added tax”); and
- (iii) The sales tax,

Imposed under the law of East Timor.

The gains accruing from the disposition of assets in anywhere in Annex F part of the JPDA is eminently subject to tax under Articles 4(1) and 4(1)(d) of the Indonesian Law of Income

² The day the TST became effective in Timor Leste.

Tax (as at October 25, 1999). The taxes imposed by the provisions of Articles 4(1) and 4(1)(d) of the said Indonesian Law of Income Tax are also taxes imposed under the law of Timor-Leste.

A combined reading of Article 4 of the TST and the relevant provisions of the Indonesian Income Tax Law creates the jurisdiction to impose tax on any gains associated with Article 11(Annex G) transactions within Annex F of the JPDA.

Based on the taxation laws of Timor-Leste, the position of NDPR is that generally, the gains from such transactions within Annex F of the JPDA are subject to 30% tax in Timor Leste.

A "Tax Object" is defined under Article 4(1) of the Indonesian Law of Income Tax Law, Law No. 10 (1994) to mean an increase in economic capability received or accrued by a Taxpayer, in whatever name or form and originating from within or without Indonesia, which can be used for consumption or to increase the wealth of the Taxpayer concerned.

The gains accrued by a corporation, partnership or other body through the transfer of property to shareholders, partners or members are includible as part of a Tax Object³.

Article 26(2) of the Indonesian Law of Income Tax Law provides:
 "With the exception of a sale of property under Article 4 section (2), income from the sale of property in Indonesia which is received or accrued by a non-resident Taxpayer other than a permanent establishment in Indonesia, and insurance premiums paid to a foreign insurance company, shall be subject to withholding tax of 20 percent (twenty percent) on the estimated net income."

Article 26(3) provides that the implementation of the provisions in section 4(2) shall be stipulated by the Minister of Finance.

On or about August 24, 1999 the Minister of Finance issued a Decision (KEP 434/KMK.04/1999) interpreting the ambit of Section 26(2). The Decision provides as follows:
 The Minister of Finance Republic of Indonesia,
 Considering:

- a. whereas in accordance with Article 26 paragraph (2) to paragraph (3) of Law Number 7 Year 1983 concerning Income Taxes as most recently amended by Law Number 10 Year 1994, income derived from the sale of property in Indonesia received or earned by Non-resident Taxpayers (WPLN) other than Permanent Establishments (BUT) is subjected to the withholding of Income Tax (PPh) of 20% (twenty percent) of the total estimated net income, the implementation of which is stipulated by the Minister of Finance;
- b. whereas on the basis of the provision in the above-referenced letter and, in order to provide certainty in respect of the provision of tax on income received or earned by WPLN other than BUT from the sale of shares, it is deemed necessary to regulate the withholding of PPh on the said income with a Decision of the Minister of Finance;

In view of:

1. law Number 6 Year 1983 concerning General Provisions and Procedures of Taxation State Gazette Year 1983 Number 49, Supplement to State Gazette Number 3262), as most recently amended by Law Number 9 Year 1994 (State Gazette Year 1994 Number 59, Supplement to State Gazette Number 3566);

³ Article 4(2)-Indonesian Income Tax Law, 1994.

2. Law Number 7 Year 1983 concerning Income Tax (State Gazette Year 1983 Number 50, Supplement to State Gazette Number 3263) as most recently amended by Law No 10 Year 1994 (State Gazette Year 1994 Number 60, Supplement to State Gazette Number 3567);
3. Law Number 1 Year 1995 concerning Limited Liability Companies (State Gazette Year 1995 Number 13, Supplement to State Gazette Number 3587);
4. Presidential Decree Number 122/M Year 1998;

HAS DECIDED:

To stipulate:

THE DECISION OF THE MINISTER OF FINANCE OF THE REPUBLIC OF INDONESIA CONCERNING THE WITHHOLDING OF ARTICLE 26 INCOME TAX ON INCOME RECEIVED OR EARNED BY NON-RESIDENT TAXPAYERS OTHER THAN PERMANENT ESTABLISHMENTS ON INCOME IN THE FORM OF PROFITS FROM THE SALE OF SHARES

Article 1

Referred to in this Decision as Companies shall be Domestic Limited Liability Companies whose shares are traded by shareholders which are Non-resident Taxpayers (WPLN) and are not issuers or Public Companies as intended in Law Number 8 Year 1995 concerning Capital Market.

Article 2

1. Income from the sale of shares of Companies earned by WPLN other than BUT shall be subject to the withholding of tax of 20% (twenty percent) of the estimated net income.
2. On WPLN domiciled in countries having Agreements on the Avoidance of Double Taxation (P3B) with Indonesia, the withholding of the tax intended in paragraph (1) shall only be made if on the basis of the P3B in force, the taxation right on the disposal is in Indonesia.
3. The total estimated net income intended in paragraph (1) shall be 25% (twenty five percent) of the sales price, that the total Article 26 Income Tax is $20\% \times 25\%$ or 5% (five percent) of the sales price.
4. The payment of the PPh (Income Tax) intended in paragraph (1) shall be final.

The following conclusions can be drawn from the provisions of KEP434/KMK.04/1999, namely:

1. The Decision is inapplicable outside the narrow scope relating to the sale of shares or comparable interest in a company. In a sale of asset transaction, the withholding tax regime of KEP434/KMK.04/1999 becomes irrelevant ;
2. the Decision is limited only to the sale of shares of a publicly traded domestic (Indonesian) Limited Liability Companies;
3. the Decision is limited only to WPLN other than Permanent Establishments;
4. the withholding tax regime is not available to issuers of the affected shares as defined under Article 1 of Law Number 8, Year 1995; and
5. the withholding tax regime is not available to Public Companies as defined in Article 1 of Law Number 8, Year 1995.

The gains arising from the sale of shares or other comparable interest (within Annex F of the JPDA) in a company with principal asset as described in Article 11 of Annex G to the TST is

subject to the withholding tax regime of KEP 434/KMK.04/1999 where the recipient Non-resident taxpayer (WPLN) can demonstrate the fulfillment of Article 1 above

The other exemption from the application of the 30% tax rate to Article 11 (Annex G, TST) transactions is as contained in Law No. 4, 1995, relating to the income of Venture Capital Companies earned from the sale of shares or the transfer of capital participation in their business partner companies.

Qualifications for the withholding tax regime stipulated in Article 1(3) of Law No.4, 1995 are:

1. that the recipient taxpayer is a Venture capital company; and
2. that the proceed was earned from the sale of shares or transfer of capital participation in a business partner company⁴.

Other than allowing for the exceptions immediately above (where applicable) in the Annex F part of the JPDA, the view of the NDPR is that the tax consequences attendant to the alienation of shares or comparable interest in a company within the JPDA are substantially the same. The gains from such transactions falling within Article 11 are subject to 30% capital gains tax in Timor-Leste.

- The fundamental difference in the tax treatments between the alienation of shares or comparable interest in a company within and without Annex F part of the JPDA as discussed above is limited to the cases where such transactions are subject to the withholding tax regime contained in certain relevant Indonesian tax laws discussed above;
- The Contractors doing business within Annex F of the JPDA at the time of the issuance of this Public Ruling cannot claim any benefits from the applicable Indonesian withholding tax regime for reasons discussed above; and
- Therefore, the tax consequences (including the 30% tax) attendant to any Article 11 (Annex G, TST) asset/property sale transaction is the same in both Annex F and Non-Annex F parts of the JPDA.

Pursuant to Article 2 (1) (c) of the Law of Income Tax, No. 10, 1994, a Permanent Establishment (PE) is a Timor-Leste domestic Tax Subject. A foreign entity doing business through a PE or merely receiving or obtaining income from Timor-Leste, other than from a PE, may be characterized as a foreign Tax Subject within the meaning of Article 2 (4). Both the domestic and foreign Tax Subjects are subject to tax under Article 2(2).

Article 4 (1) of the Law of Income Tax, No. 10/1994 defines a Tax Object to mean:

Any increase in economic capability received or accrued by a Taxpayer, in whatever name or form and originating from within or without Indonesia, which can be used for the consumption or to increase the wealth of the Taxpayer concerned, including:

- a. any reimbursement or compensation in compliance with the works or services received or obtained, including salary, wage, allowance, honoraria, commission,

⁴ Article 1(2) of Law No.4, 1995 defines "Business partner companies" as companies which (a) constitute small-or-medium-sized companies or companies engaged in business sectors as determined by the Minister of Finance; and (b) do not trade their shares on the Indonesian Stock Exchanges.

bonus, gratuity, pension payment or other compensation in any form whatsoever, unless otherwise stipulated in this Law;

- b. prize of a lottery or any work or any activity, and reward;
- c. business profit;
- d. profit due to sale or transfer of property, including:
 - 1) profit due to transfer of property to a company, association, or other body/entity in exchange for shares or capital participation;
 - 2) profit obtained by a company, association or other body/entity due to transfer of property to shareholders, partners or members;
 - 3) profit due to liquidation, merger, consolidation, expansion, division, or acquisition;
 - 4) profit due to transfer of property in the form of grant, aid or donation, unless given to family of the same blood in one degree of straight descent line, and religious institutions or educational institutions or social institutions or small-scale entrepreneurs, including cooperatives as stipulated by the Minister of Finance, as long as they do not have any relationship with the business, work, ownership or authority between the relevant parties;
- e. refund of tax payments which are already calculated as cost;
- f. interest including premiums, discounts, and compensations due to loan repayment guaranty;
- g. dividends, under any name and form whatsoever, including dividends by an insurance company to policy holders, and distribution of the remaining business profits of a cooperative;
- h. royalty;
- i. rent or other income relating to the utilization of property;
- j. receipt or acquisition of periodical payment;
- k. profits due to debt exemption;
- l. profits due to the difference of foreign exchange rate;
- m. surplus of assets re-evaluation;

- n. insurance premiums;
- o. any contribution received or obtained by any association from its members which consist of Taxpayers performing business or freelance work, as long as such contributions are determined in accordance with the business volume or freelance work of its members;
- p. any increase of net assets originating from income before tax.

Pursuant to Article 5 (Fiscal Arrangement and Taxes) of the TST, and more importantly Article 5(iii), Timor-Leste is entitled to impose taxation on its Article 4 proportionate share of petroleum revenue accruing from the JPDA activities in accordance with the laws and taxation code applicable only in Timor-Leste.

Article 5(b) of the Timor Sea Treaty provides:

“Consistent with the formula contained in Article 4 of this Treaty, East Timor and Australia may, in accordance with their respective laws and the taxation code, impose taxes on their share of the revenue from petroleum activities in the JPDA and relating to activities referred to in Article 13 of this Treaty.”

Article 13 (Application of taxation law) of the TST provides in part:

- (a) For the purposes of taxation law related directly or indirectly to:
 - i. the exploration for or the exploitation of petroleum in the JPDA; or
 - ii. acts, matters, circumstances and things touching, concerning arising out of or connected with such exploration and exploitation the JPDA shall be deemed to be, and treated by, East Timor and Australia, as part of that country.

Further to the provisions of Article 4(b) of the Taxation Code (Annex G) to the TST, the existing taxes in Timor-Leste covered by the Taxation Code are:

- i. the income tax, including either the tax on profits after income tax or the additional profits tax, as applicable to a specified petroleum project or part of a project;
 - ii. the value added tax and sales tax on luxury goods (“value added tax”); and
 - iii. the sales tax,
- imposed under the law of Timor-Leste.

Article 11 (Alienation of property) of Annex G of the TST, provides:

- 1. Where a gain or loss of a capital nature accrues to or is incurred by a person, other than an individual who is a resident of a Contracting State, from the alienation of property situated in the JPDA or of shares or comparable interests in a company, the assets of which consist (directly or indirectly, including for example a chain of companies), wholly or principally of property situated in the JPDA, the amount of gain or loss shall, for purposes of the law of a Contracting State, be an amount equivalent to the framework percentage of the amount that would be the gain or loss but for this paragraph.

By the combined effects of Articles 2(2) and 2(4) of the Indonesian Law of Income Tax, No. 10, 1994 and Article 11 of Annex G to the TST, the holder of the shares of a company doing business within the JPDA with an Article 11 transaction (sale of shares directly or indirectly or

the sale of the asset of the company within the JPDA), will effectively subject the holder to the Timor-Leste tax jurisdiction.

It is irrelevant that such a holder may be a foreign entity in its characterization as a non-resident Tax Subject, where the holder is:

- a) A body which is not established or domiciled in Timor-Leste, conducting business or carrying out activities through a permanent establishment in Timor-Leste; or
- b) A body which is not established or domiciled in Timor-Leste, receiving or accruing income from Timor-Leste other than from conducting business or carrying out activities through a permanent establishment in Timor-Leste.

Transactions in the Non-Annex F part of the JPDA from 2005 to December 31, 2007

Prior to the passage of the Taxes and Duties Act (TDA) in 2008, the taxation of petroleum revenue in the JPDA (other than the Annex F part), Directive 2001/2 (Calculation of Income Tax & Administrative Matters relating to Income Tax) and the Petroleum Taxation Act (PTA) were the primary governing laws for income taxes in Timor-Leste.

The Directive and the PTA were repealed through Section 93.1 of the TDA. Section 93.3 preserved the application of the Directive and the PTA to the transactions commenced before the commencement of the TDA. The TDA became effective from January 1, 2008.

Section 3.1 (Source of Income) of Directive 2001/2 provides:

An amount is East Timor-source income to the extent to which the amount is:

- a) income from business activities carried on:
 - i. by a resident in East Timor; or
 - ii. by a non-resident through a permanent establishment in East Timor as determined under section 26;
- b) income from alienation of any movable property, used in deriving East Timor-source income referred to in paragraph (a)
- c) income from the lease of immovable property in East Timor whether improved or not, or from any other interest in or over immovable property, including a right to explore for, or exploit, natural resources, in East Timor ;
- d) income from alienation of any property or right referred to in paragraph (c) or from the alienation of any interest in a legal person the assets of which consist wholly or principally of property or rights referred to in paragraph (c);
- e) a dividend paid by a resident legal person; or
- f) interest, royalties, a management fee, annuity, or any other income paid by a resident or borne by a permanent establishment in East Timor of a non-resident.

Section 3.2 of Directive 2001/2 provides:

“Notwithstanding Section 3.1, any amount taxable in East Timor under an international agreement is East Timor-source income.”

The sale of property, shares or comparable interest in a Permanent Establishment, the assets of which consist (directly or indirectly, including for example a chain of companies), wholly or principally of property situated in the JPDA, by a resident or non-resident shareholder is subject

to tax in Timor-Leste. Such transactions are clearly within the provisions of Sections 3(c) and (d) of the Directive 2001/2.

The interest held by a Contractor in a Production Sharing Contract (PSC) within the JPDA is interpreted as a right to explore for, or exploit, natural resources, in East Timor, and the sale of such right (wholly or partly and regardless of the form) is tantamount to the alienation of an ownership interest in a legal person, the assets of which consisted wholly or principally of property or right to explore for, or exploit, natural resources, in East Timor.

A PSC confers on the Contractors the right to explore for, or exploit, natural resources in Timor-Leste. A Contractor is defined under Section 2 of the Petroleum Taxation Act to mean: "a person with whom the Ministry or Designated Authority, as the case may be, has a Petroleum Agreement."

A "Petroleum Agreement" means:

- a) A contract, licence, permit or other authorization made or given pursuant to Petroleum Act, except for a seepage Use Authorization; or
- b) An authorization or production sharing contract made under the Code.

Natural resources are defined in Section 1 of the Directive 2001/2 to mean: mineral, petroleum, or any other living or non-living resource that may be taken from the land or sea.

The TST is an international agreement as defined pursuant to Section 1 (Definitions). Section 1 of the Directive 2001/2 defines "international agreement" to mean: "a double taxation convention having force of law in East Timor."

Pursuant to the provision of Section 3.2 of the Directive 2001/2, the TST (including Annex G), any item taxable pursuant to the TST is equally taxable in East Timor, irrespective of the fact that the item may not be within the purview of Section 3.1 (source of income).

The TST by operation of law (Section 3 of the Directive 2001/2) confers the jurisdiction to tax any such gain arising out of a Timor-Leste sourced income as provided for in Article 11 of Annex G to the Timor Sea Treaty.

Some taxpayers have argued that Section 34.1 of the UNTAET Reg. 2000/18 excludes the application of the entire Directive 2001/2 within the JPDA. The said taxpayers further argued that the **express and sole** intent of the Directive is to modify Regulation 2000/18. That view is incorrect for a number of reasons.

- The matters covered under the Directive are substantially larger than the matters covered (modifications of certain provisions and not all provisions of the Directive) under Chapter VIII of UNTAET Reg. 2000/18 and for which Section 34.2 is relevant, *Expressio unius est exclusio alterius* ("the express mention of one thing excludes all others");
- There is no limiting language in the Directive, if the Timor-Leste parliament intended a complete exclusion of the Directive to the area known as JPDA, an express and explicit language would have been inserted accordingly,
- Following the principle of *ejusdem generis* (of the same kind), the limiting language of Section 34.2 cannot be extended beyond matters covered by Chapter VIII of the UNTAET Reg. 2000/18
- Section 36.8, forming part of the excluded Chapter VII, preserves the continuous application of Section 38 of the Directive without any limiting language;

- Section 1 of the UNTAET Reg. 2000/18 supports a purposeful interpretation of the Regulation and rejects any interpretation that frustrates the intended purpose
- The definition of “East Timor” as contained in Section 1 of the Directive includes the area subject (the ZOCA) to the Memorandum of Understanding dated 10 February, 2002 and made between Timor-Leste and Australia; AND
- Implicitly, Sections 93 (Repeal) and 94 (Saving) of the TDA preserves the continuous application of the Directive 2000/2 and all other laws in effect and which are applicable to certain taxpayers within Annex F of the JPDA.

Section 5.2 (Jurisdiction to Tax) of the Directive provides:

“The Tax Object of a non-resident Tax Subject includes only East-Timor-source income.”

Tax Subjects are defined in Section 4 of the Directive to mean:

- a) a natural person
 - b) an undivided estate as a unit in lieu of the beneficiaries
 - c) a limited company incorporated in East Timor;
 - d) any other public or private legal person that has been incorporated, formed, organized, or established in East Timor, including an enterprise owned by the East Timor Transitional Administration (ETTA) or its successor as may be provided in UNTAET regulations or a political or administrative subdivision of that Administration, a limited partnership, affiliation, association, firma, kongsi, cooperative, a foundation or similar organization, or any other forms of business or non-governmental organization;
 - e) any legal person founded under a foreign law and or any other in a manner comparable to entities or bodies referred to in paragraphs (c) or (d) above, including a trust; or
 - f) any other body of persons formed under foreign law.
- With respect to transactions consummated in the non-Annex F part of the JPDA for the period between May 2002 and December 31 2007, the TST, PTA and the Directive 2001/2 apply with equal force to the alienation of property or shares or comparable interest in a company with asset (wholly or principally, directly or indirectly, including for example a chain of companies) within the Joint Production Development Area (JPDA).

The gains that accrued to the transferors (residents and non-residents alike) of such property or shares are subject to tax at 30% in Timor-Leste.⁵

Finally, Article 6.4 of the Petroleum Taxation Act contemplates the imposition of capital gains tax on Contractors by excluding certain items of income in a specific case from taxation.

Transactions in the Non-Annex F part of the JPDA from January 1 2008

Aside from the TST, the other primary taxation law governing income tax and Supplemental Petroleum Tax (SPT) in the non-Annex F part of the JPDA is the TDA⁶.

Effective from January 1 2008, the TDA became the governing law in Timor-Leste for both Contractors and Subcontractors in all matters touching and concerning the TST.⁷

⁵ Article 6.1., PTA, Section 6(b)(ii) of Schedule 1, UNTAET Reg. 2000/18

⁶ Section 70, TDA

Chapter IX of the TDA is applicable exclusively to Contractors and Subcontractors in the Timor-Leste Exclusive Area (TLEA) and the JPDA, excepting the area covered by the PSC described in Annex F of the TST.⁸

A substantial part of the repealed PTA was incorporated as Chapter IX of the TDA.⁹

Section 3 (Ambit of the Act) of the TDA provides:

Subject to Section 94, this Act applies to the territory of Timor-Leste, including its territorial sea, and to its exclusive economic zone and continental shelf, and applies to the Joint Petroleum Development Area, except that -

- (a) Chapter II does not apply to matters covered by the Timor Sea Treaty;
- (b) Chapters III and IV do not apply to goods covered by the Timor Sea Treaty;
- (c) Chapter V does not apply to imports covered by the Timor Sea Treaty;
- (d) Chapter VI does not apply to wages received in the territory covered by the Timor Sea Treaty; and
- (e) Chapter VII does not apply to the territory covered by the Timor Sea Treaty.

Chapter VII (Income Tax) of the TDA governs a taxable person, characterization and computation of taxable income but the entire JPDA is excluded from its application.¹⁰

Section 91 of the TDA provides that no taxes or duties have effect in Timor-Leste unless they are included in, or authorised by the present law.

Section 92 of the TDA provides that the legal regime relating to the collection and recovery of tax shall be set out in a Decree-Law to be adopted by the Government. No such Decree-Law has been adopted to date. However, Section 93.4 provides;

“The legal regime relating to the collection and recovery of tax shall remain in effect until such time as when a new legal regime is adopted”.

The TDA does not provide any definition as to what amounts to a “legal regime relating to the collection and recovery of tax.” Both the Directive and PTA contained administrative provisions relating to the collection and recovery of tax but the two laws, save for periods before January 1, 2008 were effectively repealed via Section 93.1 of the TDA. Section 93 (repeal) enumerates the laws that were consequentially repealed as:

- UNTAET Regulation No. 2000/18, as amended
- UNTAET Directive No. 2001/2, as amended; and
- PTA

If the UNTAET Regulation 2000/18 is preserved as a result of the saving provision of Section 93.5, the same argument can also be made for the portions of UNTAET Reg. 2001/2 and the PTA relating to the “collection and recovery of tax,” until the passage of a decree-law regulating tax procedure and which encompasses the sundry collection and recovery of tax provisions that were scattered in the three (3) separate laws.

⁷ Section 96.3, TDA

⁸ Section 69, TDA

⁹ Section 4, TDA

¹⁰ Section 3(e), TDA

The effect of that position is that there will be no changes whatsoever to the treatment of gains connected with the alienation of property or shares or comparable interest in a company with asset (wholly or principally, directly or indirectly, including for example a chain of companies) within the Joint Production Development Area (JPDA). Such gains would be taxable to both residents and non-residents in Timor-Leste at 30%.

Alternatively, even if the UNTAET Reg. 2000/18 is the only law relating to the “collection and recovery of tax” that is preserved by the Section 93.4 of the TDA to the exclusion of other laws with administrative provisions connected with the collection and recovery of taxes, the alienation of property or shares or comparable interest in a company with asset (wholly or principally, directly or indirectly, including for example a chain of companies) within the Joint Production Development Area (JPDA) will still be taxable in Timor-Leste on the strength of Article 11 (Annex G) to the TST alone.

The position of NDPR is that without more, the omnibus provision of Article 11 is a sufficient legal basis to impose Timor-Leste taxation on any transaction amounting to an alienation of property or shares in the manner described therein. The TST is part of the laws of Timor Leste, effective from May 20, 2002.

After the ratification of the TST by the Timor-Leste sovereign government, the TST (including the annexure) became a statute of general application to petroleum operations, Contractors and Subcontractors alike in Timor-Leste.

Article 13(a) (Application of taxation law) of the TST provides that for the purposes of taxation law related directly or indirectly to the exploration for or the exploitation of petroleum in the JPDA; or acts, circumstances and things touching, concerning, arising out of or connected with such exploration and exploitation, the JPDA shall be deemed to be, and treated by, East Timor and Australia, as part of that country.

To be excludible from taxation in Timor-Leste, a person deriving a gain in the circumstances described in Article 11(Annex G) to the TST has a burden of showing that such a gain is specifically precluded from taxation in Timor-Leste.

Tax deductions, exemptions, credits or similar tax benefits are matters of legislative grace and a claimant/taxpayer has a burden of showing the statutory basis for such entitlements.

Article 4(b) of Annex G defines the Taxes covered under the TST as:

- (i) the income tax, including either the tax on profits after income tax or the additional profits tax, as applicable to a specified petroleum project or part of a project;
- (ii) the value added tax and sales tax on luxury goods (“value added tax”); and
- (iii) the sales tax

Is a gain derived from the alienation of property or shares or comparable interest in a company with asset (wholly or principally, directly or indirectly, including for example a chain of companies) within the Non-Annex part of the JPDA taxable in Timor Leste after December 31, 2007?

The position of NDPR is that such gain, attributable to Timor-Leste and which is connected with the disposition of shares or property in the manner described in Article 11 of Annex G to the TST is taxable to both residents and non-residents before or after December 31, 2007 at 30% in Timor-Leste.

Factual Examples

• Situation 1

Pontius Oil and Gas Corporation (PGC) is a Contractor and a holder of a 47% participating interest in a Production Sharing Contract 33-12 (PSC 33-12) within the JPDA. PGC is organized as a special purpose entity by Pontius Global Energy Corporation (PGE), a non-resident Japanese company. The principal asset of PGC is the 47% participating interest in PSC 33-12.

PGE sold 51% of the common shares or similar interest in PGC to Santana Oil Company (SANTANA) for US\$70 million. The tax basis of PGE in the shares of PGC (is US\$17 million. PGC is a Timor-Leste resident permanent establishment (PE).

The interest held in PSC 33-12 is the principal asset of PGC.

• Situation 2

Same facts as in Situation 1 above except that PGC and PSE either jointly or severally conveyed 51% of the 47% participating interest held in PSC 33-12 to Santana in exchange for US\$ 70 million

• Situation 3

Armco Global Energy, Inc. (AGE), a US resident, owns 100% of the common stock and all of the outstanding preferred shares of Spark Consolidated Oil, Inc. (SCO). SCO is resident in Australia. SCO organized a special purpose entity named Hurricane Energy Resources, Ltd (HER). SCO owns 100% of the common shares of HER, and HER owns 50% of the participating interest in JPDA PSC 16X-P2. The 50% interest held in PSC 16X-P2 is the principal asset of HER.

The tax basis of AGE in SCO is US\$45 million. The tax basis of SCO in HER is US\$39 million. The principal asset of SCO is the stock of HER. The principal asset of HER is the 50% of the participating interest in JPDA PSC 16X-P2.

AGE sold 90% of the common stock and the outstanding preferred shares of SCO to Kitan Producing Corporation (KPC) for US150 million.

Situation 4

Same as above except:

1. The transaction was consummated before commercial discovery; and
2. The US\$39 million claimed by SCO as its tax basis in HER represented the contribution to the joint venture as part of the Geological and Geophysical expenditure.

In *Situation 1*,

Transaction in JPDA-Annex F

Article 26(2) of the Indonesian Law of Income Tax Law, KEP 434/KMK.04/1999 and Article 1(3) of Law No.4, 1995 (withholding tax) are inapplicable for reasons discussed above.

The capital gains tax payable on the transaction is approximately \$18.4 million (\$70 M-(\$17m X 51%) X 30%. The Timor Leste portion of the tax is \$16.56 million (\$18.4 m X 90%).

NDPR will hold both PGC and PGE as jointly and severally liable for the tax liability resulting from the transaction.

PGE will be required to establish the proof of capitalization of PGC PGE by demonstrating contemporaneous journal entries, bank statements, cancelled checks etc.

Transaction in JPDA- Non-Annex F

The capital gains tax payable on the transaction to Timor-Leste is the same as above (\$16.56 million).

NDPR will hold both PGC and PGE as jointly and severally liable for the tax liability resulting from the transaction. PGE will be required to establish the capitalization of PGC by demonstrating contemporaneous journal entries, bank statements, cancelled checks etc.

In Situation 2

Transaction in JPDA-Annex F

Article 26(2) of the Indonesian Law of Income Tax Law, KEP 434/KMK.04/1999 and Article 1(3) of Law No.4, 1995 (withholding tax) are inapplicable for reasons discussed above.

The amount deductible against the receipt of \$40 million proceed is dependent on the tax basis of PGC in the 47% interest held as the participating interest in PSC 33-12. The tax basis of PGE in PGC will be irrelevant in the computation of the capital gain tax attendant to the transaction as described.

PGC will also be required to establish the proof of funding or the investment in PSC 33-12

Transaction in JPDA-Non-Annex F

Same treatment as above.

In Situation 3

Transaction in JPDA-Annex F

Article 26(2) of the Indonesian Law of Income Tax Law, KEP 434/KMK.04/1999 and Article 1(3) of Law No.4, 1995 (withholding tax) are inapplicable for reasons discussed above.

The capital gains tax payable on the transaction is approximately \$32.8 million (\$150 M-(\$45m X 90%) X 30%. The Timor Leste portion of the tax is \$29.5 million (\$32.8 m X 90%).

NDPR will hold both PGC and PGE as jointly and severally liable for the tax liability resulting from the transaction.

Depending on the nature of the preferred stock, the value appropriated to the 90% of the common stock held by AGE in SCO may be revised downward and thereby reduce the tax basis.

NDPR will hold both AGE and SCO as jointly and severally liable for the tax liability resulting from the transaction. AGE will be required to establish the capitalization of SCO by demonstrating contemporaneous journal entries, bank statements, cancelled checks etc.

The value of the preferred stock held by AGE in SCO will be independently valued by NDPR.

Transaction in JPDA-Non-Annex F

Same as above in Annex F.

*In Situation 4***Transaction in JPDA-Annex F**

The issue here is whether NDPR will permit any amount invested by AGE in SCO or the amount invested in HER by SCO or through SCO as deductible tax basis in the circumstances described in Situation 4. To frame the question differently, if an Article 11(Taxation Code) transaction was consummated by AGE and SCO in the manner described in Situation 3 but before commercial discovery, will NDPR allow any amount as deductible as tax basis against the proceeds (\$150 million) received from the alienation of 90 % of the shares of SCO by AGE?

The principal asset of SCO is HER and HER holds 50% participating interest in JPDA PSC 16X-P2. The sale of 90% of the shares of SCO to KPC as described in Situation 3 is tantamount to the alienation of shares in a Company with asset (wholly or principally, directly or indirectly, including for example a chain of companies) within the Joint Production Development Area (JPDA). The transaction is therefore within the ambit of Article 11 of the Taxation Code of the TST.

A substantial part of the pre-commercial discovery/pre-production expenditure of a Contractor is traditionally constituted by acquisition costs, geological and geophysical (G&G) costs, support equipment, explorative and development drilling costs etc. Such costs are required to be capitalized when incurred in Annex F of the JPDA¹¹. Such intangible costs, developed or acquired, are only deductible from the date of the first production as stipulated in Sections 5(1)(c) and 5(2)(c) of TBUCA.

Furthermore, Section 16 (Transfer of Rights or Stakes in a Petroleum Project) of TBUCA provides:

1. In the event all the stakes held by a contractor in a petroleum project are transferred or assigned to another contractor, the acquiring contractor shall be treated as if he or she had the same gross revenues and deductible expenses, concerning the rights or stakes held by the transferor or assignor, just before the transfer or assignment occurred. For the purposes of calculating the accrued net revenues of the acquiring contractor in the tax year in which such transfer or assignment occurs, the accrued net revenues of the transferring or assigning contractor, at the closure of the previous tax year, shall be treated as the accrued net revenues of the acquiring contractor in the previous tax year.

2. In the event that just a portion of the contractor's rights or stakes in a petroleum project is transferred or assigned to another contractor:

(a) The acquiring contractor shall be treated as if he or she had received the gross revenues and incurred the deductible expenses pertaining to that portion of the rights or stakes held by the transferring or assigning contractor, in relation to the totality of a right or stake, just before the occurrence of the transfer or assignment, multiplied by the percent transfer factor; and

(b) For the purposes of calculating 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 transferring or assigning contractor, at the closure of the previous tax year, multiplied by the percent transfer factor, shall be treated as the accrued net revenues of the acquiring contractor in relation to the previous tax year.

¹¹ Section 5(1)(c) & 5(2)(c), Taxation of Bayu-Undan Contractors Act, Law No. 3/2003.

3. For the purposes of this section, “percentage factor of transfer” is the percentage of a 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 assigning contractor in the petroleum project before the occurrence of the transfer or assignment.

By the combined effect of Sections 5(1)(c), 5(2)(c) and 16 of TBUCA, the transferor of a property subject to Article 11 of the Taxation Code of the TST and which property is located within Annex F part of the JPDA will not be allowed to claim the tax basis of the transferred property against the proceeds received if the transaction was consummated before the commencement of the first production. In Scenario 4 described above, KPC will “inherit” such intangible costs as stipulated in Section 16 of TBUCA. Effectively the entire proceed (less any transaction costs) received by AGE for the sale of 90% of the common stock of SCO to KPC will be subject to tax at 30%.

Some taxpayers have argued that the provisions of the TBUCA are inapplicable to the fact pattern described in Situation 4. They argued that the provision of Section 116 is specific to Bayu Undan Contractors and only relevant to Additional Petroleum Tax (APT), and which has a special project taxation rule which ignores gains/losses on the sale and purchase of interests in projects.

NDPR rejects such a view as misleading and incorrect, both in law and in fact. The TBUCA is not exclusive to APT matters. It covers a whole gamut of tax issues unrelated to APT. For example, Section 2-10 of TBUCA has no direct bearing on APT.

NDPR will extend the application of Section 16 of TBUCA in the circumstances described in Situation 4. To do otherwise, NDPR will be facilitating a “double-dip” opportunity over the same tax asset for the transferor and the transferee inheriting the “deductible expenses” of the transferor under Section 16 (2)(a) of TBUCA. If the transferee is deemed to have inherited the G&G expenses of the transferor as stipulated under Section 16(2)(a) of TBUCA, and the same expenses may for part of the depreciable or amortizable asset after the commencement of production, it is inconceivable that the same “asset” will be allowed as a tax deductible basis to AGE and or SCO in the transaction and circumstances described in Situation 4.

In Situation 4

Transaction in JPDA- Non-Annex F

Other than the applicable laws, the tax consequences of the transaction described in Situation 4 in Annex F are exactly the as those in Non-Annex F in similar circumstances.

Section 77.5 of the TDA provides:

“Notwithstanding anything in Sections 36 and 37, a depreciable asset or intangible acquired, created, constructed, or incurred by a Contractor before commercial production is depreciated or amortised from the commencement of commercial production. Commercial production commences on 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 the thirty-day period reaches a level of regular production delivered for sale determined by the Tax Administration, with the advice of the Ministry or Designated Authority, as the case may be.”

Section 79 (Transfer of Interest in Petroleum Agreement) of the TDA provides:

“If a Contractor transfers an interest in a Petroleum Agreement:

- (a) The transferee Contractor continues to amortise any Exploration or Development Expenditure in the manner and on the same basis that the original Contractor amortized the expenditure; and
- (b) Sections 36 and 37 apply to any other depreciable assets or intangibles at the rates specified in the Schedule X.”

Furthermore, Section 88 (Transfer of Interest in Petroleum Operations) of the TDA provides:

88.1. If the whole of a Contractor’s interest in Petroleum Operations is transferred to another Contractor, the transferee Contractor is treated as having the same gross receipts and deductible expenditures in respect of the interest as the transferor contractor had immediately before the transfer.

For the purposes of calculating the transferee Contractor’s accumulated net receipts for the tax year in which the transfer occurred, the transferor Contractor’s accumulated net receipts at the end of the previous tax year is treated as the transferee Contractor’s accumulated net receipts for that previous year.

Section 88.2: If part of a Contractor’s interest in Petroleum Operations is transferred to another Contractor:

- (a) The transferee Contractor is treated as having the gross receipts and deductible expenditures in respect of that partial interest as the transferor Contractor had in relation to the whole interest immediately before the transfer multiplied by the transferred percentage factor; and
- (b) For the purposes of calculating the transferee Contractor’s accumulated net receipts for the tax year in which the transfer occurred, the transferor Contractor’s accumulated net receipts at the end of the previous tax year multiplied by the transferred percentage factor is treated as the transferee Contractor’s accumulated net receipts for that previous tax year.

88.3 In this Section, “transferred percentage factor” means the transferor Contractor’s percentage ownership of the Petroleum Operations that is transferred divided by the transferor Contractor’s total percentage ownership in the Petroleum Operations prior to the transfer.

In spite of the difference in language, the tax effect of Sections 77.5 and 88 is exactly on all fours with that of Sections 5(1)(c) and 4(2)(c) of TBUCA. Similar to the tax consequences in Annex F in Scenario 4 described above, KPC will “inherit” the intangible costs as stipulated in Section 77.5 of the TDA.

The entire proceed (less any transaction costs) received by AGE for the sale of 90% of the common stock of SCO to KPC in the circumstances described in scenario 4 above will be subject to tax at 30% if the transaction involved the alienation of property within the Non-Annex F part of the JPDA.

Some taxpayers have also challenged the basis of NDPR’s position relating to the joint and several liability of any related entities involved with an Article 11(Annex G) transactions.

The principle of joint and several liability is well entrenched in common law jurisdiction as well as a good number of civil law countries (where it is described as “solidarity obligation”) and it is applicable in cases where the right to demand payment of the whole claim from two related or similarly situated parties involved in the transaction creating the claim, and payment by one of them discharges the debtor completely. The paying party retains the right of subrogation. Most Article 11(Annex G) transactions (transferring shares and or selling other properties) would ordinarily involve **both** the entity with a PE status in Timor-Leste and the “owners’ of the shares of the PE or the “alter ego” of the PE.

The Principal author of this Public Ruling is Mr B.W. Boye Esq., Petroleum Revenue Legal Advisor, NDPR (bboye@mof.gov.tl).

Dated February 1, 2012

The effective date of this Public Ruling is May 20, 2002 and it is applicable to any and all transactions within Article 11 (Annex G) of the Timor Sea Treaty.

This Public Ruling is issued by:

**Câncio de Jesus Oliveira
Director General & Tax Commissioner
Directorate of Revenue & Customs
Timor-Leste**