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Indices of Treaty Abuse and the Various Fiscal Regimes for Regulating Onshore and Offshore Energy Sectors

Anyaelezu Somachi
International Oil and Gas Lawyer, Llb, Bl, Llm – Aberdeen, Scotland

Abstract:
Under international law, a state is permitted to tax foreign transactions as long as there is sufficient nexus between the tax payers and the taxing state, which gives the taxing state the right to tax the income of either the individual or legal entity on the basis of source or residency principles.[1] Under the source principle, a state has the right to tax any income that is derivable from any activity of a taxpayer within its territorial scope, irrespective of whether the earner of the income has any other connection with the state (e.g., is a resident of that country).[2] On the other hand, the principle of residency permits a state to tax the world wide income of any person that has a substantial connection to that taxing jurisdiction and hence qualifies as a resident under the laws of that state. Therefore, a state having a complete sovereignty to create a tax system, may adjust these principles to its needs o reduce double taxation and combine them under a consideration of its economic and political realities.[3]

As a consequence of these principles, more than one state can have concurrent jurisdiction over the same income creating an overlap, which leads to double taxation. This overlap generates an excessive tax burden on the taxpayer which may globally inhibit the free exchange of goods and services, thereby having a negative effect on the development of international capital flows.

In order for countries to avoid the problem of double taxation, most developed countries enter into a bilateral or rarely multilateral treaty,[4] generally referred to as DTR convention (Double Taxation Relief Convention) or DTT (double taxation treaties).[5] Double tax convention (DTC) can also be seen as double tax treaties, as it embodies the double tax reliefs of the both countries that are parties to the treaty.[6]

In most cases, some persons try to abuse the provisions of these treaties by circumventing the limitations provided by that treaty. Example of such situations are treaty shopping, splitting of contracts, Hiring-out of labor, Avoidance of Dividend Characterization, Dividend Transfer Transactions, Transaction that circumvents the Application of Article 13 (14) of OECD, tiebreaker Rule For Treaty Residence, Permanent Establishment situated in third countries.[7]

This work is a review of how countries treaty network is abused, the negative effects of treaty abuse and recommendations of how treaty abuse can be cubed. It will also consider the different fiscal regulations which a country can adopt for the purpose of regulating its offshore and onshore energy sectors.

1. Introduction

Whenever different countries interact in the taxation sphere, the problem of conflict of tax jurisdiction arises.[8] Countries establish their jurisdiction over tax matters unilaterally, or in agreement with another country or countries (Bilaterally).[9] As taxable profits or gains arise from sources in more than one country, taxation of such profits or gains might duplicate action in another jurisdiction.[10]

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[1] Simosne M. Haug," The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis", (Vanderbilt Journal of Transnational Law Vol. 29, 1996) P.195-199, available @>Hein Online http://heinone.org>accessed 20th April, 2017.

[2] Ibid.

[3] Ibid.

[4] There are more than 2500 double taxation Treaties worldwide and UK has the largest of Treaties, covering over 100 countries. The UK seeks to encourage and maintain an international consensus on cross-border economic activities and to promote international trade. To this end, UK plays an important role in the Organisation for Economic Co-operation and development. (OECD), available on line @>http://www.hmrc.gov.uk/taxtreaties/dta.htm>accessed 2oth April, 2017.

[5] Angharad Miller &Lynne Oats," Principles of International Taxation", (3rd Ed, Bloomsbury Professionals, 2011) p.78.

[6] Idid.

[7] Organisation for Economic Co-operation and Development (OECD), BEPS ACTION 6, "Preventing the granting of Treaty Benefits in Inappropriate Circumstances", (2014) available @>http://www.oecd.org/ctp/treaties/ treaty- abuse-discussion-draft-march-2014.pdf>accessed 20th April, 2017.

[8] Roy Saunder, "Understanding Double Tax Treaties", (2002) Journal of International Trust & Corporate Planning, Vol.9, Issue 1. p. 7.

These are numerous advantages that accrue from tax treaties that different countries agree to grant to each other in order to prevent double taxation and to remove the barrier that double taxation would create to cross-border trade, investment and more.[11]These advantages come in the form of exemption from tax in one or the other country; reduction in the withholding taxes on dividends, interests and royalties and foreign tax credit.[12]

Tax treaties are concluded between two or more countries with a primary purpose of eliminating double taxation, while providing for administrative, legal assistance and information exchange on tax matters.[13] This situation has been observed not without issues arising. The problem of "double taxation" is normally remedied by specific domestic legislation and international tax treaties.[14]

The domestic legislation has to do with the fiscal regulations in place in a country.[15] Fiscal regulation or fiscal regime can be defined as the sum of all imposition on an investor by the state through a legislative mechanism.[16] The fiscal regime in a country should function in way that not only minimizes economic risks to the state but also makes the sector more attractive for oil companies and welcome investors.[17] Examples of fiscal regime which countries adopt to achieve these objectives include but not limited to bonuses, royalties, corporate income tax (CIT), rents, petroleum resource rent tax (PRRT), tax on extra ordinary profit (TEP) or wind fall tax etc.[18] There are wide ranges of fiscal systems with different taxation terms which varies from country to country, and some countries may use more than one system.[19] The main issue for every country will be how to make the best use of their fiscal regulations to maximize much profit from their resources.

2. Ways in Which a Country's Treaty Network May Be Abused

2.1. Treaty Shopping

This is viewed as involving the improper use of the double tax agreement (DTA), in a situation where a person acts through an entity set up in another state with the main intent of obtaining treaty benefits which ordinarily would not have been available to such a party.[20] Treaty shopping is often referred to as "treaty abuse" or "tax avoidance", even though it has long been regarded as a legitimate instrument of international tax planning.[21]

The Supreme Court of India in the case of UNION OF INDIA VS AZADI BACAO ANDOLAN defined treaty shopping as " A graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two contracting states.[22] From OECD point of view, treaty shopping occurs when a third country resident takes advantage of a bilateral treaty that is intended to benefit only residents of the contracting states.[23] In other countries however, the term may be used more broadly, not necessarily involving a triangular arrangement, even though the purpose of which is to take advantage of treaty imposed exemptions and withholding rates upon the repatriation of income to non-treaty nations.[24]

Nevertheless, treaty shopping is generally believed to have more negative than positive effect on a country's economy as such, a 'plague' that must be dealt with.[25] Some of such effects include; loss of revenue,[26] impediment of the principle of reciprocity,[27]

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[9] Simosne M. Haug (n1).

[10] Ibid.

[11] Philip Baker," Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion", (Papers on Selected Topics in Administration of Tax Treaties for Developing Countries, 2013) available on line @>http://www.un.org/esa/ffd/tax/2013TMTTAN/Paper9A Baker.pdf>accessed 15th, April, 2017.

[12] Simone M. Haug (n1).

[13] Ibid.

[14] Alexander Trepelkov et al, "Administration of Double Tax Treaties for Developing Countries", (2013) United Nations New York, p.1.

[15] Ibid.

[16] Allan Russell, Wayne G. Bertrand, "Fiscal regime changes for maximising oil recovery from offshore continental shelf oil fields" (2012), available @>http://sta.uwi.edu/conferences/12/revenue/document/WayneBertrandandAllanRussell.pdf>accessed 15th, April, 2017.

[17] Ibid.

[18] Jinyan Li, "Beneficial ownership in tax treaties: judicial interpretation and cases for clarity'‘, (New York University, Osgoode Law School, Research paper series 2012) available @>http://papers.ssrn.com/sol3/papers.cfm?abstract _id=2000816>accessed 5th April, 2017.

[19] Ibid.

[20] Treatypro, the on-line Tax Treaty Resource>treatypro.com/features/treaty_shopping_572028.html.

[21] Dietmar Anders, " The Limitation on Benefit Clause of the U.S-German Tax Treaty and its compatibility with European Union Law (1997-1998) Nw.J.Int'l L.& Bus,P.165, available @>http://scholarlycommons.law.northwestern.edu/njiib>accessed 15th April, 2017.

[22] Union of India Vs Azadi Bacao Andolan (2003) SC 56 ITR 563.

[23] Organisation for Economic Co-operation and Development (OECD) Commentary 2003.

[24] Raymond Wacker, "Anti-Treaty Shopping Restrictions in the New U.S-Netherlands Tax Treaty", (1993) 45 Tax Executive, p.383-384, available @>http://heinonline.org/HOL/Landing Page? Handle=hein.journals/taxexe45&div=144&id=&page=>accessed 5th March, 2017.

[25] Ibid.

[26] Simosne M. Haug (n1) p. 216-218.

reduction of incentive to conclude treaties, [28] elimination of taxation (double non-taxation), [29] lack of effective exchange of information, [30]

2.2. How Treaty Shopping Works

Some of the transactions in which treaty shopping can arise are examined below:

2.2.1. The Use of Equity Funds to Side Step Withholding Tax Requirements for Dividend Payments

This is achieved by setting up controlled foreign companies in appropriate jurisdictions that operate favorable tax incentive treaties and channeling dividends through them.[31]

2.2.2. The Use of Base Arrangement

Under the base arrangement, income is shifted through an interposed corporation which can be a partnership, trust or other entity having taxable status under the domestic law of the third state to a country that has an advantageous treaty.[32] The base company only serves as a pass-through entity through which the income received from a related company in one country is redistributed to the share holder in another country, the sole purpose of which is to minimize tax in the country of residence where the investor resides.[33]

2.2.3. The Use of a Conduit

Under the conduit method on the other hand, the interposed entity seeks to obtain tax advantages in the source country where the economic substance of the investment is located.[34] It is important to note that this transaction only works if the conduit company itself enjoys some level of tax exemption and the income must pass through the conduit entity to the beneficial owner with the minimum of withholding taxes.[35] Most of such arrangements pass through tax heavens and under these arrangements; the income involved may change its character several times during the transfer. For example, from dividend to interest income or vice versa.[36]

2.2.4. Creation of "Shell" Companies by 3rd Parties to Enjoy Undeserved Benefit under the Treaty of Contracting States

Under treaty shopping transactions, some companies are merely created as a "shell" company with no staff or business operation, or sometimes may be managed by unrelated local trust companies with the sole motive of minimizing tax.[37] Even though the motive of the creator of such company cannot be easily ascertained, the degree of the activity of an interposed entity and its nature can help ascertain the true motive of the creator.[38]

Thus, the OECD report observed that such arrangements leading to treaty shopping are usually detrimental to the source state since by the existence of the treaty, it has ceded tax jurisdiction of the conduit's purported state of residence.[39]

3. Other Ways Third Parties Abuse the Double Taxattion Treaties

3.1. Splitting of Contacts

This is a situation whereby enterprises split their contracts into several parts and among different companies in order to escape the twelvemonth permanent establishment threshold for construction or installation projects in Article 5(3).[40] These in most cases are usually carried out through the contractors or subcontractors.[41]

3.2. Avoidance of Dividend Characteration

Here the transactions are entered into by the taxpayers with the intention of avoiding dividend characterization of certain income under domestic rules. This situation now allows a characterization of that income depends on the provisions of a treaty to prevent source country taxation.[42]

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[27] Ibid.
[28] Ibid.
[29] Lynette Oliver and Michael Honiball, " International Tax: A South African Perspective" (5th Ed, Siber Ink Publishers 2011)p.352
[30] Ibid
[31] Angharad Miller &Lynne Oats (n5)
[32] Christiana H.J.I Panayi, "Double Taxation, Tax treaties, Treaty Shopping and the European Community", (Kluwer Law International 2007) P. 37.
[33] Simosne M. Haug (n1) p.205-207.
[34] Ibid
[35] Ibid.
[36] Raymond Wacker (n24).
[37] Ibid.
[38] Jinyan Li (n18).
[39] Ibid.
[40] Organisation for Economic Co-operation and the Development (OECD) Model Tax Convention 2010.
[41] OECD, BEPS ACTION 6 (n7).
[42] Ibid.

3.3. Hiring-Out of Labour

This is achieved by using foreign workers employed by an intermediary; the taxpayers attempt to enjoy the benefits of the tax exemption from source country as contained in Article 15(2) of the OECD Model Tax Convention 2010.

3.4. Dividends Transfer Transaction

Here tax payers enter into transactions that seek to obtain a reduced dividend rate under Article 10 (2) (a) of the OECD Model Tax Convention 2010. For instance, a corporate shareholder's holding is increased in a dividend pay or primary for the aim of obtaining a reduction of withholding rate, or certain tax-advantaged intermediary entities may be established in the source state to exploit treaty provisions that lower the source taxation of dividends or shell companies or indirect portfolio investments may be established to avoid being taxed on dividends received from other domestic entities.[43]

3.5. Transaction that Circument the Application of Article 13(4)[44]

This is achieved by structuring the ownership of immoveable property through other corporations, such as partnerships or trusts, or by establishing other assets to be contributed to an entity shortly before a sale in order to dissolve the proportion of value gotten from immoveable property situated in the contracting state below the 50% threshold. Under the provision of this article, a contracting state is allowed to tax capital gains which are earned by a resident of another state on shares that in the period the profit was made, derive more than 50% of their value from immoveable property situated in the first state.[45]

3.6. Permanent Establishments Situated in Third Countries

Transactions that seek to establish permanent establishments in the third countries in order to profit from the benefit of an exemption or lower tax rate on such establishment in the third countries in order to profit from the benefit of an exemption or lower tax rate on such establishment given by the state of residence are considered to be abusive.[46]

4. Techniques and Mechanism for Cubing Treaty Abuse

Treaty abuse has for long been a highly sensitive problem globally, and in response to this, governments of countries have adopted different measures to address the issue of treaty abuse. The OECD model contains a range of provisions which may be included in bilateral treaties to prevent treaty abuse.

This part of the work will discuss briefly below those provisions under the OECD and other counter measures which can be adopted to curb treaty abuse.

4.1. Look through Approach

It is contained under Para 13 of commentary on article 1 of the OECD model convention 2010. Under this provision, it denies treaty benefits to entities which are directly or indirectly owned by persons who are residents of any of the contracting states to the entity. This approach tries to unveil the identity of shareholders of an entity in order to attribute treaty benefits to corporations.[47] The reason behind this method is that some companies are mere sham with no business or staff, but created for the singular purpose of maximizing tax. This method is usually used where one of the parties is a lower or no tax jurisdiction, having a higher risk of conduit establishment.[48]

4.2. Beneficial Ownership Approach

It is contained under Para 10 of the commentary on article 1 of the OECD model tax convention 2010. This provision generally restricts treaty benefits such as withholding taxes on interest, dividends and royalties which are located to conduit entities that are not beneficial owners of a particular income even though such structure under the treaty was formally attributed as beneficiary under the treaty. According to the OECD report on conduit companies, for a conduit company to be regarded as a beneficial owner and therefore entitled to benefit from the treaty, it must not have very narrow powers as a nominee or agent of the shareholders of the conduit company.[49] The term beneficial ownership has been a major source of controversy among commentators and court decisions,[50] since neither the OECD nor its commentary explicitly define the term. The OECD model convention only provided under Article 3(2) of the OECD model convention that the term beneficial owner should be interpreted according to the meaning given to it under the domestic

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[43] Ibid.

[44] OECD Model Tax Convention 2010.

[45] OECD, BEPS ACTION 6 (n7).

[46] Ibid.

[47] Patson W.Arinatiwe, "Securing Double Taxation Reliefs: Tightening the Rope around Treaty Shopping", available @>https://www.academia.edu/2611030/securing_double_taxation reliefs_tightening _the _rope_around_treaty_shopping>accessed 4th March, 2017.

[48] Angharad Miller &Lynne Oats (n5)

[49] Patson W. Arinatiwe (n46).

[50] Indofood International Finance Ltd V JP Morgan Chase Bank, NA London Branch (2006)ECWA, CIV, 158; Real Madrid F.C V Oficina Nacional De Inspeccion (2006) West Law Arabzadi JUR, Ministre De L' Economi, Desfinances Et De L' Industrie V Societe Bank of Scotland NO283314, 91TLR1.

legislation of contracting states. Examples of such provisions are contained in Indonesia-Maritina treaty and Indonesia-Netherlands treaty.[51]

4.3. The Channel Approach or Base Erosion Approach

Under Para 17 of the commentary on article 1 of the OECD model convention 2010, it stipulates that DTT should contain provisions that singles out transaction which make use of conduit arrangement in order to obtain treaty benefits as amounting to treating abuse. This approach prevents companies which are merely used as a channel for payment of income to the resident of a 3rd country from benefiting from the treaty between contracting states. Example of this is seen in article 22 of Belguim-Switzerland treaty of 1978.[52]

4.4. Subject to Tax Approach

It is contained under Para 15 and 16 of the commentary on article 1 of the OECD model convention of 2010, which allows treaty benefits in the source state to be granted to entities only if income of such entities are subjected to tax in the state of residence. It has however been argued that this method may unjustly affect entities such as charitable organizations, pension funds entities etc who under the domestic laws of the contracting states are not subjected to tax. Example of this approach is adopted under article 23(2) of the Swiss-German double taxation convention of 1980.[53]

4.5. Limitation on Benefit Clause (Lob Clauses)

It is contained under Para 20 of the commentary on article 1 of the OECD model convention 2010. LOB provisions included in DTT's prevent persons who are not residents of the contracting states from benefiting from the treaty through the mechanism of establishing an entity in the contracting states in order to qualify as residents of one of the contracting states. It, thus, helps to preclude persons from manipulating their tax residence status for the purpose of benefiting from a treaty.[54] There are series of tests which residents of a contracting state must pass before they can benefit from the treaty such as public company test, ownership/base erosion test, and active business test.[55] Example of LOB clauses is found in article 7 of US-Netherland tax treaty.[56]

4.6. The Limitation of Residence Approach

Under article 4 of the OECD model convention 2010, this rule is to the effect that persons who are not subjected to comprehensive taxation or full liability to tax by reason of his/her residence in any of the contracting states is precluded from benefiting from the treaty. The term residence is limited in scope under the treaty itself or domestic laws to persons who are obliged to pay taxes by reason of their residence, domicile, place of management etc.[57]

5. Other Counter Measures for Cubing Treaty Abuse

5.1. The Exclusion Approach

Conduit legal entity which are set up for the sole purpose of benefiting from a treaty may do so by making use of not having to pay dividends through directs conduit method, or through stepping stone method which allows the transfer of income through the use of tax deduction expenses or by establishing a specific conduit company which is categorized as a tax-exempt under the treaty.[58] As a result of this, the exclusion approach excludes some particular forms of legal entities from benefiting under the treaty. Some or all types of income which is derived by corporations may also be excluded.[59] See for example the German-Canadian tax treaty of 1984 which excludes tax-favoured Canadian nonresident owned investment corporation.[60]

5.2. Bonafide Provision Approach

The bonafide provision included in the DTT's helps to prevent benefit of the treaty from accruing to companies that are not bonafidely established in either of the contracting states.[61] The purpose of this approach is to protect genuine conduit entities which carry on bonafide business transaction, since not all conduit companies are fraudulently established to minimize tax. Here conduit entities are

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[51] Patson W. Arinatiwe (n46).
[52] Ibid.
[53] Ibid.
[54] Angharad Miller &Lynne Oats (n5).
[55] Under Article 4 of the OECD Model Convention 2010, the term "resident of a contracting state" means any person who under the laws of that state is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature and also includes that state and any other political subdivision or local authority thereof, this term however, does not include any person who is liable to tax in that state in respect only of income from sources in that state or capital situated therein".
[56] Christiana H.J.I Panayi (n27)
[57] Patson W. Arinatiwe (n46).
[58] Simosne M. Haug (n1) p. 205-207.
[59] Ibid.
[60] Income Tax Act, RSC,CH.1 (1985) S.133
[61] Angharad Miller &Lynne Oats (n5) p. 495.

subjected to some level of test like stock exchange or market test, active business or trade test, motive test, etc, in order to identify if such companies are merely established for the purpose of obtaining benefit under the treaty.[62]

5.3. Inclusion of General Anti-Abuse Rule (GAAR) or Specific Anti-Abuse Rule (SAAR) in Domestic Laws and Treaties

Some countries such as Australia, US, France, Canada, New Zealand have incorporated the provisions of either an SAAR or a GAAR in their domestic laws in order to curb treaty abuse. For example, US enacted a form of GAAR which entrenches the economic substance doctrine which allows courts to scrutinize various tax minimizing scheme in order to prevent companies which are solely established to avoid tax from benefiting from such a scheme.[63] In a similar vein, other treaty countries have also incorporated domestic tax laws controlled foreign corporation regime (CFC) to protect the domestic tax abuse erosion.[64]

In many cases, SAARs are also incorporated in the treaty itself to deny benefits to entities which are established widely to avail tax benefits not intended by the treaty.[65] The importance of anti-treaty abuse provisions cannot be over emphasized. The Supreme Court of India in the case of INDIA V AZADI BACHAO ANDOLAN (SUPRA)[66] while interpreting the Indian Mauritius treaty affirmed that tax treaties supports an inherent anti-treaty abuse provisions, as the purpose of DDT's is to avoid tax evasion and tax avoidance.

The idea of an inherent anti-abuse principle was also affirmed by the Swiss Federal Court in the case of A HOLDINGS APS V FEDERAL TAX ADMINISTRATION, [67] where the Federal Court of Switzerland relied on an inherent anti-abuse principle to deny a reduced withholding tax rate under the Switzerland-Denmark treaty on dividends paid to a Danish company whose sole shareholder was a Guernsey corporation whose sole shareholder was a corporation in Bermuda.[68] The court here held that "because the prohibition of abuses is part of the principle of good faith…the prohibition of an abuse of rights as regards conventions is…recognised…without being necessary to adopt an explicit provision in the respective convention".

Also, the court of Israel in YANKO-WEISS HOLDINGS (1996) LTD V HOLON ASSESSING OFFICE, [69] applied an inherent anti-abuse principle in order to deny treaty benefits to a company which was originally incorporated in Israel but subsequently changed its place of management to Belgium and registered as a Belgian company in order to access benefits under the Israel-Belgium treaty.

5.4. Abstinence Approach

By this approach, many countries such as US have tried to curb treaty abuse by abstaining or terminating their treaties with tax heaven or low tax countries.[70]

6. OECD Recommendations to Curb Treaty Abuse

In consideration of the ways in which third parties exploit the DTR conventions (OECD Treaty) particularly seen as treaty abuse, this work has tried to review ways in which these DTR conventions are abused, and also suggested different ways to address these abuses. This part of the work will however consider changes that need to be affected in a country's DTR convention as proposed by OECD in order to curtail cases of treaty abuse. It will start by considering the changes already proposed by OECD and different writer's responses to it before recommending the needed changes.

The OECD Report on the impact of BEPS has also labeled the treaty abuse as one of the high priority action items for developing countries.[71] According to the OECD, it is inefficiencies in tax treaties that have triggered double non-taxation in a number of situations.[72]

It is recommended in the OECD public discussion draft that the following three prolonged approach should be used to address treaty shopping situations and other treaty abuses. First, it recommended, that contracting parties when entering into a treaty should state clearly in the title and preamble their wish to prevent tax avoidance and, in particular, intend to avoid creating opportunities for treaty shopping.[73]

Secondly, parties should include in tax treaties a specific anti-abuse rule based on the limitation on-benefits provisions as included by the United State and a few other countries.[74]

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[62] Ibid.
[63] Ibid.
[64] Christiana H.J.I Panayi (n27).
[65] Ibid.
[66] India V Azadibacho Andolan (supra n22)
[67] A Holdings ApS vs Federal Tax Administration (2005) 8 ITLR 536.
[68] David G. Duff, "Responses to Tax Treaty Shopping: A comparative Evaluation", available @: http://ssrn.com/abstract=1688689 >accessed 10th, April 2017.
[69] Yanko-Weiss Holdings (1996) Ltd vs Holon Assessing Office (2007) 10 ITLR 254.
[70] The US had 21 tax treaties with tax heaven or low tax countries which were all terminated in 1986, only the treaty with Barbados, 1 tax treaties (CHH) 1103 (1986) was renegotiated.
[71] Taxes, "Newsletter of the International Bar Association Legal Practice Division", (September 2013) Vol. 19, N0 2, available @>http://www.altenburger.ch/uploads/tx_altenburgerteam/LT_2013_Taxes_Newsletter_International_Bar_Association.pdf>accessed 7th, April, 2017.
[72] Ibid.
[73] OECD Public Discussion Draft, 2014.
[74] Ibid.

Thirdly, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the specific anti-abuse rule described in the preceding paragraph (such as certain conduit financing arrangements), it is recommended to add to tax treatise a more general anti-abuse rule.[75]

Other recommendations included where the proposals for specific treaty anti-abuse rules included dealing with some specific forms of treaty shopping, such as strategies aimed at using a permanent establishment.[76]

Furthermore, states should properly consider the treaty arrangement before deciding to enter into a tax treaty with another country. However, the approaches that are recommended here are not restricted to treaty shopping cases and will also contribute to preventing the granting of treaty benefits in other inappropriate circumstances, this being particularly the case of the general anti-abuse provision.[77]

By September 2014, OECD proposed for the prevention of tax treaty abuse that at minimum a tax treaty should always include:

i) A principle purposes test (PPT) rule;

ii) A limitation on benefit (LOB) rule supplemented by a mechanism, such as restricted PPT rule, that would deal specifically with conduit arrangements; or

iii) A combined approach (i.e. including both LOB and PTT rules.)

It went further to propose certain targeted anti-avoidance clauses, together with changes to the title, preamble and commentary on the OECD Model Tax Convention to clarify that the prevention of tax evasion and avoidance, specifically including but not limited to treaty shopping, is one of the purposes of a double tax treaty.[78]

Therefore the LOB should now include a "derivative benefit" provision allowing certain entities owned by residents of other states to obtain treaty benefits that these residents would have obtained if they had invested directly.[79] The PPT is identical to the provisions March 2014 OECD Discussion Draft version except with the substitution of "Principal", purpose for "main" purpose regarding obtaining a treaty benefit, unless granting that benefit would be in accordance with the object and purpose of the relevant provisions of the treaty in question.[80] The report went further to recommend that treaties include in their title and preamble a clear statement that the contracting states when entering into a treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. Another aspect of Item 6 of BEPS Action Plan is an examination of measures, ' to clarify that tax treaties are not intended to be used to generate double non -taxation'.

On 16th September 2014, OECD released a report on Action 6, and on Friday, 21 November 2014, OECD released another Public Discussion Draft which noted that further work needs to be done with respect to the precise contents of the OECD Model Convention provisions and related commentary, particularly with regard to the Report Draft of Limitation on Benefits (LOB) article as an alternative means of addressing treaty shopping. The 21st November OECD Discussion Draft identifies twenty (20) issues. The first ten (10) issues relates to the content of the LOB article and related commentary. The next 7 issues relate to the Principal Purpose Test, followed by three other issues relating to the residency tie-breaker rule, an anti-abuse rule relating to income exempted from resident country taxation by virtue of being attributable to a permanent establishment in a third country and the interaction between tax treaties and domestic anti-abuse rules.[81]

However, many of the respondents to the OECD draft are concerned mainly on the fact that the new measures if put in place, would seriously reduce the ability of cross-border investors to claim legitimate treaty benefits, which in turn could have negative impact on the global economy by reducing international trade and investment.[82]

Authors like BIAC have shown concerns over the different layers of rules that are presently proposed in the OECD treaty draft model, which included LOB article, GAAR, series of SAAR.[83] They see these three-pronged approaches as unnecessarily burdensome, as these are in addition to the pre-existing rules, such as beneficial ownership of income. They concluded that these layers of rules to curb treaty abuse will add to considerable complexity, cost and uncertainty. They further suggested that the model convention should make provision for either the LOB or the GAAR and not both for the purpose of addressing treaty abuse.[84] They went further to state that the application of the benefits of a treaty should not be as an abuse, Therefore there should be a clear and common understanding

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[75] Ibid.

[76] Ibid.

[77] In February 2013, the journey for tax treaty abuse began to make another head way when OECD released its preliminary BEPS Report to address Base Erosion and Profit Shifting on the use of tax-efficient business structuring by multinationals to reduce group corporate tax liability. By July 19, 2013, it released its much anticipated BEPS Action Plan which it claims provides " a global roadmap that will allow governments to collect the tax revenue they need to serve their citizens" while giving "businesses the certainty they need to invest and grow".

[78] Lynette Oliver and Michael Honiball (n45) p.12.

[79] Raymond Wacker (n24)

[80] Ibid.

[81] 21 November 2014, the OECD, Public Discussion Draft

[82] Alexander Trepelkov, Harry Tonino and Dominika Halka, " United Nations Handbook on selected Issues in Administration of Double Tax Treaties for Developing Countries", (United Nations New York, 2013). P.11

[83] Ibid.

[84] Ibid

of what should be considered as a treaty abuse. Companies should not be seen to be abusing treaty benefits when there is a genuine business established, attracted by the treaty benefit in place, entered for the purpose of attracting businesses.[85]
The author of this work agrees that GARR and SARR should be put in the body of treaties to help the treaty address its problem by itself. Notwithstanding the importance of incorporating these anti-treaty provisions in order to curb treaty abuse, it is however strongly advised that care should be taken as the presence of these anti- treaty provisions can reduce investment.

7. Fiscal Regimes for the Regulation of Onshore and Offshore Energy Sector
Fiscal regime is defined as the sum of all impositions on an investor by the state through a legislative mechanism.[86] Oil and gas resources are no doubt infinite and as such, oil and gas countries always seek to attract foreign investment as well as receive a share of its economic rent generated from its oil and gas extraction for the purposes of maximizing its economy.[87] To achieve this, a competitive, stable, neutral design of fiscal regime is pivotal.
There are wide ranges of fiscal regime instruments which are employed by countries to regulate its on shore and offshore energy sector.[88] This part of the work will consider some of the fiscal regimes such as bonuses, royalties, corporate income tax (CIT), petroleum resource rent tax (PRRT), tax on extra ordinary profits (TEP) or wind fall tax, government or state equity, ring fencing, withholding taxes (WHTs), petroleum transaction tax (PTT), petroleum production tax (PPT), production income tax (PIT), supplementary charges. It will also discuss their advantages and disadvantages as well as how these fiscal regimes can be applied in different countries for the purposes of developing their economy.

7.1. Royalties
These are taxes which are paid to the host government (HG) usually at the start of production to compensate it for granting a right of extraction and production of its oil and gas resources to the international oil companies (IOC).[89] Most royalties are either measured advalorem (based on percentage of the value output) or per unit (based on a fixed amount). [90] For example, under the laws of Algeria, royalties which are due on gross income are paid by the NOC at a rate of 20% to 16.25% or 12.% for zone A and B respectively, but can be further reduced by the ministry of fiancé to a rate of 10%.[91] Royalties are disadvantageous to the HG, in the sense that, royalties being a simple addition to cost can make extraction of some resource deposits unviable.[92] It can also cause significant disruption since its effect is to erode the total of pre-tax rents which is to be shared between the HG and IOC.[93] For example, a 20% royalty or 40% minimum profit oil share to the state which allows only 50% of the available oil production cost can reduce initial investment by 20% and the extra rate by approximately 1% point per year.[94]Also, when an overall fiscal regime is based on royalties, they become more complex because requirements are needed to make them more profitable making use of proxy measures like price, location, production level etc. Royalties above all are regressive and high level rates of royalties distort business decision.[95]

7.2. Bonuses
It is an upfront payment which the IOC pays to the HOG for acquiring exploration rights of its oil and gas resources.[96] Bonuses can be very large, for example, over $1billion was a top bid in Angola's 2006 round, or it could be a modest sum like in USA's offshore auction.[97] There are two types of bonuses, the signature and production bonus. The signature bonus are paid by the IOC on the effective day of the signature (at conclusion or finalization of the contract between the parties), whereas, production bonus are fixed

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[85] Ibid.
[86] Allan Russell, Wayne G. Bertrand (n16).
[87] Ibid.
[88] Wdapwilapo Selma Shimutwikeni, "What is a competitive fiscal regime for foreign investment: with special reference to Namibia and Bostwana", available @>http://www.dundee.ac.uk/cepmlp/gateway/?news=31320>accessed 7th March, 2017.
[89] Natural Resources governance institute (NRGI), "Oil, gas and mining fiscal terms", available @>http://www.resourcegovernance.org/training/resource_centre/backgrounders/oil-gas-and-mining-fiscal-terms>accessed 5th March, 2017.
[90] James Otto et al, "Mining royalties: A global study of the impact on investors, government and civil society", (The bank for reconstruction and development/world bank), (2006), available @>http://www.siteresources.worldbank.org/INTOGMC/Resources/336099-1156955107170/miningroyaltiespubication.pdf>accessed 7th, March, 2017.
[91] Law N086-14 (2005) and Law N0 0507 (2013).
[92] International Monetary Fund, "Fiscal regimes for extractive industries: Design and implementation" (2012), available @>http://www.imf.org/external/np/pp/eng/2012/081512.pdf>accesed 10th April, 2017.
[93] Ernst and young. "Global oil and gas tax guide", (2015), available @> http://www.ey.com/Publication/vwLUAssets/EY-2015-Global-oil-and-gas-tax-guide/$File/EY-2015-Global-oil-and-gas-tax-guide.pdf>accessed 2nd, April, 2017
[94] Ibid.
[95] Thomas Baunsguard et al," A premier on mineral taxation, International Monetary Fund", (IMF) Working Paper WP/01/139 (2001), available @>http://www.imf.org/external/pubs/ft/wp/2001/wpo1139.pdf>accessed 10th April, 2017.
[96] NRGI (n 84).
[97] IMF (n87)

payment made on achieving a certain cumulative production or production rate.[98] According to IMF report, the problem with signature bonus is that, it may become a sunk cost for companies that they may only recover in the event that the project is successful, and because they are sunk, it may pose some level of political risk if a project is especially profitable.[99]

7.3. Corporate Income Tax (Cit)

CIT which is viewed as a blunt instrument for reaching rent is one of the core components of a country's fiscal regime.[100] Most oil and gas countries subject oil companies to general income tax rate prevailing for all businesses in the country. In Algeria for instance, the NOC on behalf of IOC pays a 38% income tax, which applies to profits made by a foreign partner. It is usually included in the profit oil received by the NOC and is calculated by subtracting the royalties paid by the IOC, the transportation cost, amortization costs, exploration costs which are incurred by the IOC from the gross income.[101]

Further, CIT's offer more positive benefits to HG in the sense that when they are used in onshore and offshore industry, it helps ensure that normal return to equity is taxed at a corporate level; it minimizes the risk of HG fiscal loss in the event that the exploration and production (E&P) projects turns out unprofitable.[102] Also, tax based on CIT will adjust to changes in profitability unlike royalties that would respond less to changes in profitability especially where royalties are imposed on valued basis.[103] CIT are more neutral, progressive unlike royalties since payments are differed until the IOC recovers their production cost. However, a high CIT rate can discourage investment by increasing the required pre-tax return. CIT also requires more capacity building in order to monitor abuse of treaty arising from transfer pricing.[104]

7.4. Petroleum Resource Rent Tax: (PRRT)

It is increasingly used in countries offshore and onshore sector. For example, in Australia, PRRT applies to all onshore projects and offshore projects (North West shelf) which is deductible for income purposes.[105] Under the PRRT, investors receive an annual uplift on any accumulated losses until they are recovered. The uplift rate is thus set at the minimum required rate of return for investors. PRRT is usually applied with ring fencing by license and can be accessed before or after CIT.[106] One of the advantages of PRRT is that it increases investment if the uplift rate of the capital expenditure exceeds the companies' cost of capital, even though it has been argued that such incentive of inflating cost can lead to negative marginal effective tax rate and an implicit subsidy to resource extraction.[107] Resource rent tax is also neutral to investment decisions and more attractive to investors even though it may be difficult to monitor and handle.[108]

7.5. Ring Fencing

It is a type of tax regime operational in UK, Denmark, China, etc, which separates taxation of activities of oil companies on a project-by-project basis in order to facilitate the government to collect tax revenue on a project each year that it earns a profit.[109] Petroleum activities are ringed fenced for the purposes of tax so that loses which accrue from petroleum activities may not be set off against profits from other countries.[110]

The advantages of ring fencing is that it prevents loses from other sectors of the country which is applied against petroleum profits. It is also used to combat tax avoidance wherein companies set up multiple activities within one country and used losses incurred in one project, say exploration expenses from a new mine that has not yet begun production to offset profits earned in another project, thereby reducing the overall tax.[111] The disadvantage of ring fence is that, a too-tight ring fence discourages exploration and investment activities by existing firms.[112]

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[98] Ibid.
[99] Ibid.
[100] Allan Russell, Wayne G. Bertrand (n16) P.11.
[101] Ernest and Young (n88).
[102] Thomas Baunsguard et al (n 90).
[103] Ibid.
[104] NR GI (n 84).
[105] Ernst and Young (n88).
[106] Allan Russell, Wayne G. Bertrand (n16).
[107] Thomas Baunsguard et al (n 90).
[108] Thomas Baunsguard et al, "Fiscal frame works for resource rich developing countries", (International Monetary Form Staff Discussion Note) SDN/12/04 (2012), available @>http://www.imf.org/external.pubs/ft/sdn/2012/sdn1204.pdf>accessed 18th, April, 2017.
[109] Ibid.
[110] Nathan Meehan, "Types of international petroleum fiscal regimes: Ring fencing, Reserves treatment", (2015) available @> http://blogs.bakerhughes.com/reservoir/2011/06/18/types-of-international-petroleum-fiscal-regimes-ring-fencing-reserve-treatment/> accessed 5th, April, 2017.
[111] Ernst and Young (n88).
[112] Nathan Meehan (n105).

7.6. Tax on Extraordinary Profit (TEP)/ Windfall Tax

They are special tax instruments which the government puts in place to achieve a greater share of project surplus, through additional tax payments when prices or profits exceed the level which is necessary to attract investment.[113] In Algeria for instance, TEP applies to rates which are derivable from the output of shares of foreign partners of NOC when the arithmetic average price of oil exceeds $30 per barrel.[114] The TEP rate here also ranges from 5% to 50%, depending on the type of contract entered into between the IOC and NOC.[115]

7.7. Government/State Equities

It is a type of quasi fiscal instrument used by government of different countries to secure additional government take beyond tax revenue from profitable projects.[116] It is motivated by a non fiscal desire to protect a countries ownership of her natural resources. State equity is of different types such as; fully paid up equity-wherein government pays its share of any cost, thereby putting the government in the same footing with the investors, carried equity-where by government contributes with the investors and recovers from the dividend with the interest, and free equity where government receives a percentage of dividends without payment of cost.[117] In Columbia for example, IOC are expected to pay equity tax accruing from 1 January payable in an outright equal installments over 4years, and in 2014, they are expected to pay as equity tax liquidated and declared in 2011 in two equal installments during the year.[118] State equity is advantageous to the HG in the sense that it gives the state access to a high portion of dividend payments. It also minimizes risk of a fiscal loss to HG, since government pays for its equity share out of production proceeds, there will be no direct losses covered by the government in event where the project turns unprofitable.[119]

7.8. Production Income Tax (PIT)

They are usually monthly tax rates paid by the IOC based on the volume of production of oil and gas resources since the beginning of the production (accrued production).[120] Under the PIT, taxes and expenses paid and incurred by the IOC as royalties, annual investments for exploration and development, reserves for abandonment or restoration costs, training costs are also deductible in computing the PIT. In Angola, the applicable PIT rate is usually 35%, even though tax losses may be carried forward for only 5years.[121]

7.9. Petroleum Production Tax (PPT)

This is calculated on the quantity of crude oil and natural gas measured at the well head and on other substances less the oil used in production as may be approved by the state concessionaire.[122] In Angola for instance, this tax rate is 20% but may be reduced by 10% by the government or upon petition by the state concessionaire in certain situations such as in cases of oil exploration in marginal fields, offshore depths exceeding 750 meters or onshore areas which the government has previously defined as difficult to reach.[123] This tax is however deductible for the computation of PIT but however not imposed under a production sharing agreement (PSA).[124]

7.10. Petroleum Transaction Tax (PTT)

This is computed on taxable income which considers several adjustments in accordance with the tax law applicable. In Angola for instance, the tax rate is 70%.[125] This tax is deductible for the computation of PIT as well.[126] Deduction of production allowance is also possible here on the basis of the concession agreement.[127] PPT, SF, TTC and financing costs are not deductible to compute the taxable basis.[128] Just like PPT, PTT is not also imposed under a PSA agreement.[129]

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[113] Government United Kingdom, " Review of the oil and gas fiscal regime: Call for evidence", (2014), available @> http://blogs.bakerhughes.com/reservoir/2011/06/18/types-of-international-petroleum-fiscal-regimes-ring-fencing-reserve-treatment/>accesed 3rd April, 2017.

[114] Ernst and Young (n88).

[115] Ibid.

[116] Thomas Baunsguard et al (n 103).

[117] Ibid.

[118] Columbia Law 1370 of 2009 and Decree 4825 of 2010

[119] Thomas Baunsguard et al (n 103).

[120] Allan Russell, Wayne G. Bertrand (n16) p.12.

[121] Decree Law N0 10/07 of Angola and other related tax laws.

[122] Ernst and Young (n88).

[123] Ibid.

[124] Ibid.

[125] Gabinete Juridico," Republic of Angola Law on Taxation of Petroleum Activities", (2004), available @>http://www.eisourcebook.org/cms/files/attachments/fiscaldesign/Angola%20%20Petroleum%20Taxation%20Law%202004.pdf>accessed 2nd April, 2017.

[126] Ibid

[127] Open Society Initiative for Southern Africa-Angola (OSISA-Angola), "Oil Revenues in Angola: Much more information but not enough transparency", (2010), available @>https://www.globalwitness.org/sites/default/files/library/oil%20revenues%20in%20angola_0.pdf>accesed 4th, April, 2017.

[128] Ibid

8. Conclusion

Countries differ from each other in terms of economic priorities, administrative capacity, petroleum endowment, and as such, it will be overly difficult to identify a particular fiscal regime instrument it can adopt to achieve its desired objective.

No particular regime can be said to be ideal but it all depends on what they have and how they wish to manage it. However, a combination of state equity, CIT, RRT, which would be targeted explicitly on rent would have a positive effect on country's onshore and offshore investment. Considering that state equity ensures that some level of revenue accrue to the government whenever production is positive, while the CIT ensures that a normal return to equity is taxed at a corporate level in the offshore and onshore oil sector. These also ensure that foreign tax credit will be available where the investing companies' home countries tax them on worldwide income, therefore drawing more investment to country.

RRT on the other hand is suggested because it explores the distinct revenue potentials of the IOC in the onshore and offshore oil sector. For government of any country to capture sustainable revenue for its onshore, offshore oil and gas resources, it must simultaneously provide sufficient incentives that attracts and sustain investment such as reduction of tax rates or tax holiday, loss carry forward provisions for an unlimited period, investment tax credits, accelerated depreciation allowance etc. A country's fiscal regime must be neutral for it to be competitive, as a non neutral tax component can negatively affect the government's net revenue and discourage investment.

A country's fiscal regime should be stable this will attract investors, and give government the expected rate of return. This can only be achieved if the government of a country combines tax instruments that targets both profits and revenues such as CIT. Developing countries that wishes to achieve a competitive fiscal regime that will help attract investment, should forgo royalty taxes, based on its disadvantages and also because investors prefers to be taxed by their ability to pay.

It is further recommended that countries should reduce reliance indirect taxes such as unit or value based royalties but should rather increase reliance on profits based taxes such as CIT.

In further response to the double tax treaty abuses, countries should be mindful of not imposing restrictions on actual treaty benefits. This is because the main aim of treaties cannot be defeated while protecting a treaty. Thus a country's long them policy goal should be focused on growing liberalization of world trade, economic flows and not be overly anxious of protecting her resources. Therefore, only international tax harmonization can help achieve this policy of growing liberalization. In designing fiscal systems, it is important to create an alignment between the companies and host government's interests as well as make adjustments as the regime must favor both parties to attract investors and accumulate revenue for the country.

Countries with treaty networks should also contribute greatly to tax harmonization by extending their treaty network to other countries while restricting the complexity of their anti-treaty provisions to an administrable extent.

The author of this work also suggests that there should be a proper assessment of the treaty risks before entering into it and also a mandatory clause that parties have the liberty to exit such treaty in situation of continuous abuse. This is in line with the comments of different authors and organization against the amendment proposed by OECD.

Further, government of any country with a treaty network should set up a firm policy for the valuation of transactions between related parties, linking the parties utilised for revenue allocation assessments to objective market values, as this will help curtail treaty abuse mechanism such as transfer pricing. Effective corporation and exchange of information between contracting states (treaty partners) can also help curb treaty abuse.

Also, a clear definition of the term beneficial ownership should be incorporated in a contracting countries DTR convention to avoid the problem arising from domestic definition of ownership.

More importantly, multilateral agreements and tax treaty harmonization is advised as being very essential to help curb treaty abuse.

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