

PUBLIC CONSULTATION DOCUMENT

Provision on Activities in Connection with the Exploration and Exploitation of Extractible Natural Resources

16 November 2023 – 4 January 2024



Public Consultation Document

**Provision on Activities in Connection with
the Exploration and Exploitation of
Extractible Natural Resources**

Public consultation instructions

Article 5 of the OECD Model Tax Convention on Income and on Capital (the OECD Model) deals with the definition of permanent establishment.

Working Party 1 on Tax Conventions and Related Questions (which is the subgroup of the OECD Committee on Fiscal Affairs in charge of the OECD Model) has recently undertaken work on the Commentary on Article 5 to develop an alternative provision on activities in connection with the exploration and exploitation of extractible natural resources, together with related commentary.

The changes put forward in this discussion draft are expected to be included in the next update to the OECD Model and its Commentary.

The Committee invites interested parties to send their comments on this discussion draft before **4 January 2024**. These comments will be examined at the following meeting of Working Party 1.

Comments on this discussion draft should be sent electronically (in Word format) by email to taxtreaties@oecd.org and may be addressed to:

Tax Treaties and International Co-operation Unit, OECD/CTPA

Please note that all written comments received will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

This document is a discussion draft released for the purpose of inviting comments from interested parties. It does not necessarily reflect the final views of delegates to Working Party 1.

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1 Input sought

Working Party 1 on Tax Conventions and Related Questions has recently undertaken work to amend the Commentary on Article 5 to include an alternative provision on activities in connection with the exploration and exploitation of natural resources, together with related commentary.

Interested parties are invited to comment on all aspects of the proposal below. In particular, the Committee would value input on the following questions:

1. The proposed alternative provision covers only activities connected with extractible natural resources (oil, gas and minerals), as explained at paragraph 187. Is there a case for extending the provision to cover the harnessing of renewable resources such as hydroelectric, wind, wave, tidal or solar power?
2. Are there particular challenges of profit attribution to the short-duration permanent establishments that this provision would create? What are they and how should they be addressed?
3. The paragraph on capital gains in the new provision (paragraph 4) largely replicates the rules in Article 13 of the OECD Model. But subparagraph *c*) allows the aggregation of movable and immovable property for the purposes of triggering a rule modelled on Article 13(4). Are there particular challenges in doing that?
4. The provision contains an exclusion for the operation of ships or aircraft *designed or modified*, and used, for the primary purpose of (i) transporting supplies or personnel, or (ii) towing or anchor handling. Is the “designed or modified” a useful extra condition, and would there be any practical difficulties in applying it?
5. Are the vessels mentioned as examples at paragraph 184 as within and outside the provision the right ones?

2 Proposed changes to the Commentary on Article 5

1. The following would be added after paragraph 169 of the Commentary on Article 5 (with paragraph numbers changed as appropriate):

The taxation of activities in connection with the exploration and exploitation of extractible natural resources

170. This section of the Commentary sets out an alternative provision that States could use to govern the taxation of enterprises in the extractive industries. Its centrepiece is a lower permanent establishment threshold, which would be crossed after a non-resident enterprise had operated in a State for more than 30 days. The provision is similar to that found in some 200 existing bilateral tax treaties, which States agreeing to such an approach could use with confidence – bringing greater consistency and certainty of interpretation. It is drafted as a free-standing article for use in a bilateral tax treaty based on the Convention.

171. Countries with abundant extractible natural resources (oil, gas and minerals) face policy choices concerning their exploitation. Implications for jobs and the effect on the environment, for example, are among the issues to be considered. But countries will certainly look to secure for themselves an adequate share of the value that is bound up in the resources that they own and which is due, in part at least, to their finite nature. How countries secure that share of the value is a complex matter, and will depend on factors unique to each country, to the non-resident enterprises, and to the resource in question. Typically, countries will use several instruments to optimise their return on the exploitation of those resources – for example, production-sharing contracts, up-front bonus payments, ongoing royalties, as well as corporate income taxes (possibly in a ring-fenced regime with a higher rate).

172. Guidance on how to deploy these instruments, and other possible ones, is beyond the scope of this Commentary. Instead, the starting point of this section of the Commentary is that States have agreed bilaterally, taking all considerations into account, to enlarge the taxing right of the source State over profits from the exploitation of its extractible natural resources by non-resident enterprises beyond what a treaty following the Convention would otherwise deliver – and to do so through lowering the permanent establishment threshold.

173. Some of those considerations, emphasised by States that do not favour this provision, are the increased compliance and administrative burdens due to the presence of more permanent establishments, with the attendant difficulties of attributing profits (or losses), especially where the permanent establishment can last for only 30 days. Striking a balance between the source and the residence State is a matter for bilateral negotiation. But source States should be mindful that the extraction of natural resources can be a difficult, risky, and technically advanced process, and the investing enterprise may require a higher return than would an enterprise operating in a less risky industry. It is therefore important that in allocating greater taxing rights to the source State, this post-tax rate of return for the enterprise is not lowered excessively, especially for pre-existing investments.

174. However, the alternative provision set out here recognises that some States choose, and other States agree, to adopt a regime for the taxation of profits in the extractive industries that is more in favour of the source State – especially where activities are carried out offshore – and that this is most frequently done by setting a lower permanent establishment threshold than would follow from the provisions of Article 5. The point is that under Article 7 a State may tax the profits of non-resident enterprises (which may be disproportionately involved in the extractive industries, especially in small countries) only if those enterprises carry on business in that State through a permanent establishment. That condition will likely be fulfilled for onshore exploitation activities – a mine, for example, will generally constitute a permanent establishment – and the same might be true for offshore exploitation activities themselves. But offshore exploration and various service activities connected with offshore exploration or exploitation may be of short duration and may not take place at a geographically fixed place of business (see also paragraph 48 above) – which would mean they were not performed through a permanent establishment within the meaning of paragraph 1 of Article 5.

175. Some States consider that a provision restricted to offshore activities is sufficient because, as just mentioned, the main site for onshore activities – a mine, for example – will generally be a permanent establishment for a non-resident enterprise doing the mining. Furthermore, short duration and mobile services may be more prevalent in the offshore sector. These services can be highly profitable, and the places they are performed may not fall within the definition of a permanent establishment in paragraph 1 of Article 5.

176. Other States might see a need for a provision that covers both offshore and onshore activities in order to capture a fuller share of the value of those onshore resources. The activities of some enterprises carrying out work connected to onshore finite natural resources – such as engineering or consultancy services or seismic surveys – might otherwise fall below the permanent establishment threshold. For example, a mining operation may require the services of individuals resident in a neighbouring country whose activities, without this provision, would not create a permanent establishment under either paragraph 1 of Article 5 or under the alternative provision for services in paragraph 144 above. Another feature of a provision covering onshore activities is that it would treat non-resident service providers carrying out similar work offshore and onshore equally. However, bringing onshore activities within the scope of the provision could set up a difference in treatment for an enterprise that was, for example, performing similar advanced technical work at both a mine and a factory. States will want to balance these considerations when deciding on the geographical scope of the provision.

177. Given the multiplicity of existing bilateral provisions governing the taxation of activities in connection with the exploration and exploitation of natural resources, some of which may not operate as intended, the Committee considered that it would be helpful to offer a standard provision that States that wanted a different taxation treatment of such activities could use in their bilateral treaties. The following is an example of such a provision. It is based in large part on existing practice and therefore reflects certain policy choices that States have made.

Activities in connection with the exploration and exploitation of extractible natural resources

1. The provisions of this Article shall apply notwithstanding the provisions of Articles 5 and 13.

Offshore only

2. For the purposes of this Article, the term “relevant activity” means an activity carried on offshore in connection with the exploration or exploitation of the seabed and its subsoil and their natural resources.

Offshore and onshore

2. For the purposes of this Article, the term “relevant activity” means an activity carried on in connection with the exploration or exploitation of the seabed and its subsoil and their natural resources. The term also includes the exploration for and exploitation of onshore finite natural resources, and other specialised activities carried on in connection therewith.

However, the operation of ships or aircraft designed or modified, and used, for the primary purpose of (i) transporting supplies or personnel, or (ii) towing or anchor handling, or the operation of other vessels that are ancillary to the exploration or exploitation of the seabed and its subsoil and their natural resources, does not constitute a relevant activity.

3. Where an enterprise of a Contracting State carries on relevant activities in the other Contracting State for a period or periods exceeding in the aggregate 30 days in any twelve month period commencing or ending in the fiscal year concerned, the relevant activities carried on in that other State shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State.

4. Gains derived by a resident of a Contracting State from the alienation of:

a) immovable property referred to in Article 6 (including exploration or exploitation rights) pertaining to natural resources situated in the other Contracting State; or

Offshore only

b) movable property forming part of the business property of a permanent establishment which that resident has in that other State and which is used in connection with the exploration or exploitation of the seabed and its subsoil and their natural resources situated in that other State; or

Offshore and onshore

b) movable property forming part of the business property of a permanent establishment which that resident has in that other State and which is used in connection with the exploration or exploitation of the seabed and its subsoil and their natural resources, or onshore finite natural resources, situated in that other State; or

c) shares or comparable interests, such as interests in a partnership or trust, if at any time during the 365 days preceding the alienation these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from property mentioned in subparagraphs a) or b) or from such property taken together:

may be taxed in that other State.

Paragraph 1 of the provision

178. This paragraph provides that the provision shall apply notwithstanding the provisions of Articles 5 and 13 of the Convention, which might otherwise preclude the taxation by a State with finite natural resources of certain income and gains derived in connection with the exploration and exploitation of those

resources by a non-resident. Conversely, where the source State maintains its taxing right by virtue of Articles 5 or 13 but not by virtue of this provision, that taxing right continues.

Paragraph 2 of the provision

179. This paragraph defines the term “relevant activity” and it has two forms: one for States that wish to confine the scope of the article to offshore activities, and one for those that wish to include onshore activities.

180. The reference to activities carried on “offshore” means, for a Contracting State, activities carried on within the area of its internal or archipelagic waters, its territorial sea, and any area beyond its territorial sea in which, in accordance with international law, it may exercise its sovereign rights with respect to the seabed and subsoil and their natural resources.¹ The above terms have the meaning ascribed to them in the United Nations Convention on the Law of the Sea 1982, which codifies this aspect of what is now generally regarded as customary international law. This paragraph is without prejudice to paragraph 1 of the Commentary on Article 3, which notes that: “In addition to the definitions contained in the Article, Contracting States are free to agree bilaterally on definitions of the terms ‘a Contracting State’ and ‘the other Contracting State’. Furthermore, Contracting States are free to agree bilaterally to include in the possible definitions of ‘Contracting States’ a reference to continental shelves.”

181. In both cases, through the use of the expression “in connection with”, the term “relevant activity” includes not only the activities of exploration and exploitation themselves, but also the performance of certain related services. The paragraphs below explain how these services are generally performed within the fields of exploration and exploitation.

182. For offshore activities there is a specific exclusion for the activities of certain vessels. But the relevant activities otherwise include all activities connected with the exploration and exploitation of natural resources. In practice, given the remoteness and difficulty of offshore activities, services performed offshore (e.g. saturation diving on the seabed and the laying of pipelines) are frequently exclusively associated with the exploration and exploitation of natural resources.

183. For onshore activities, the use of the qualifying word “specialised” restricts the coverage of related services to those that are tailored to the onshore exploration and exploitation activities. Examples include the assembly, installation and maintenance of specialised mining infrastructure and equipment, the performance of engineering and consultancy services, and the carrying out of seismic surveys. But supplying a mine operator with electricity, water or Internet access – or even a monthly delivery by road of provisions from a cross-border supplier – are generic (non-specialised) services that fall outside the scope of the provision.

184. Following the same logic, the language at the end of the provision that applies to both its forms contains a specific exclusion for transportation, towing, anchor handling, and other ancillary vessels. Towing services include those services performed by tugboats, and encompasses services that assist in the moving of ocean vessels in and out of port and between berths, towing (pushing) of barges, and transporting port pilots to ships waiting to enter a ship channel or port. Ancillary vessels include those used for fire-fighting and rescue support. But the following types of vessels carry out core activities to natural resource exploitation and are hence not covered by the exemption: oil production ships; drilling rigs; accommodation platforms; service platforms in stationary position; pipe-laying barges; seismic survey vessels; and heavy-lift barges.

¹ Argentina disagrees with this definition and considers that States may define themselves in their bilateral treaties in accordance with their domestic laws.

185. Article 8 already provides that the profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State. Therefore, although some transportation vessels may already in effect be excluded from the operation of this provision because their journeys fall within definition of “international traffic”, this specific exclusion from the operation of the alternative provision is a wider one. But the profits from the operation of these excluded vessels are nevertheless subject to the ordinary rules of Article 5 and Article 7.

186. The formulation “in connection with” is also used in a temporal sense, and includes equivalent activities at every stage of the process of extracting natural resources: exploration (when preliminary surveys take place, exploratory rights are acquired and the exploration itself happens); development (when the necessary infrastructure is built); production (when the resources are extracted, processed, transported, marketed and sold – processes that could together be described as “exploitation”); and decommissioning (when infrastructure is removed and sites are rehabilitated).

187. In referring to “the seabed and its subsoil and their natural resources”, or “onshore finite natural resources”, the provision encompasses the extraction of commodities such as hydrocarbons, precious metals, metal ores, rare earth elements and other minerals. Following the logic of paragraph 171, it does not cover, for example, the harnessing of renewable resources such as hydroelectric, wind, wave, tidal or solar power.

188. Some treaties that include an article similar to this provision exclude from scope those activities mentioned in paragraph 4 of Article 5. Following the more common practice, in the interests of simplicity, and recognising that these activities can be high-value, this provision does not do that; it also seems less appropriate to include such a provision for activities that can already be of a much shorter duration than would normally take place in a permanent establishment. Nor does it seem as likely that activities covered by this provision (both offshore and onshore) would be of a preparatory or auxiliary character. Nevertheless, States that wish to provide for such exemptions could do so – for example, by adding to the end of paragraph 3 the words: “, unless the activities of such enterprise are limited to those mentioned in paragraph 4 of Article 5 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 of Article 5 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”

Paragraph 3 of the provision

189. Where an enterprise of a Contracting State carries on relevant activities in the other Contracting State for more than 30 days, this paragraph deems those activities to be carried on through a permanent establishment in that other State. Activities carried out anywhere else are not relevant to the assessment of whether a permanent establishment is deemed to exist in that other State. For example, analysis of satellite imaging data or other geophysical data carried out in State R by an enterprise that is a resident of State R is irrelevant to the question whether the enterprise has a permanent establishment in State S, even though that is where the deposits to be explored may be located.

190. Once a permanent establishment is deemed to exist, the source State may tax the non-resident enterprise’s profits attributable to the deemed permanent establishment in accordance with Article 7 and the residence State will eliminate double taxation in accordance with Article 23. There is no requirement that the activities are attached to the same project or performed for the same customer; the test is only one of duration in the source State. The usual rules of Article 7 will apply to the attribution of profits to that deemed permanent establishment.

191. The use of a 30-day activities-based permanent establishment threshold reflects the most common choice of period in the bilateral treaties that contain these provisions. However, States whose main concern is that activities (especially those taking place offshore) are inherently mobile and may therefore never be

carried on through a fixed place of business, but who consider that a 30-day threshold is otherwise too short, may prefer to use a threshold of 183 days, or any other period.

192. Paragraph 3 of the provision refers to activities “in the other Contracting State”. In order to protect their taxing rights over activities beyond their territorial sea, it is an established practice for States to define themselves by using a formulation that (for example) includes the area in which, in accordance with international law, they may exercise their sovereign rights with respect to the seabed and its subsoil and their natural resources. (See the Commentary on Article 3.)²

193. Paragraph 3 contains no anti-contract splitting rule, for the reasons set out at paragraph 52 above. But some States may nevertheless wish to deal expressly with such abuses, especially those States that do not include in their treaties the principal purposes test at paragraph 9 of Article 29. Such a provision could be drafted along the following lines:

For the sole purpose of determining whether the 30-day threshold in paragraph 3 has been exceeded, where an enterprise of a Contracting State carries on relevant activities in the other Contracting State and substantially the same relevant activities are carried on in that other State during different periods of time by one or more enterprises closely related to the first-mentioned enterprise within the meaning of paragraph 8 of Article 5, these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on the relevant activities.

This rule would not require the relevant activities to be performed at the same location but only that the relevant activities carried on by one or more closely related enterprises were “substantially the same” (rather than “connected”, as in the provision in paragraph 52). The expression “substantially the same” would apply to the same type of resource and method of exploration or extraction. So, for example, it would not permit the aggregation of drilling activities on the continental shelf with on-shore exploration and mining, or of geomagnetic field analysis at sea with seismic exploration on land. There would be no minimum period during which the fragmented activities had to take place to fall within the scope of the rule. This reflects the fact that the 30-day period specified in paragraph 3 of the provision is substantially lower than the 12-month period in paragraph 3 of Article 5.

194. The anti-contract splitting rule above refers to one or more enterprises closely related to the first-mentioned enterprise “within the meaning of paragraph 8 of Article 5”. This is because the Convention defines the term there for the purposes of paragraphs 4.1 and 6 of Article 5. States adopting the rule might prefer to move the definition from paragraph 8 of Article 5 to paragraph 1 of Article 3 – in which case the words “within the meaning of paragraph 8 of Article 5” above would be deleted.

Paragraph 4 of the provision

195. This paragraph deals with the taxation of gains, assigning to the source State the primary right to tax gains from the disposal of certain assets (immovable property, certain movable property, and shares and other comparable interests). The source State’s right to tax these gains will generally be preserved by the operation of paragraphs 1, 2 or 4 of Article 13. However, paragraph 4 of the provision brings together the rules governing the treatment of each category of extractives-related income and gains, thereby providing transparency and clarity. Subparagraphs a), b) and c) describe the assets in question. Subparagraph c) is a potential expansion of the taxing right under paragraph 4 of Article 13.

196. Subparagraph a) confirms that, for purposes of the application of paragraph 4, exploration and exploitation rights pertaining to natural resources are within the definition of immovable property. These

² Argentina disagrees with this definition and considers that States may define themselves in their bilateral treaties in accordance with their domestic laws.

rights fall within the definition of immovable property in Article 6 (either explicitly or for example as property accessory to immovable property), and thus also fall within the ambit of paragraph 1 of Article 13. It is not considered necessary to define an exploration or exploitation right. Because a partial right is itself a right, the term also encompasses arrangements such as farm-in and farm-out agreements, under which, for example, the owner of an oil or gas interest (the farmor) assigns part of it (as opposed to the whole of it) to another person (the farmee), in exchange for certain obligations – e.g. to share the cost of a project, to perform some service, or just to make a cash payment.

197. Subparagraph b) is in two parts (offshore only, and offshore and onshore) and encompasses a gain derived by a resident of a Contracting State from the alienation of movable property forming part of the business property of a permanent establishment and used in connection with the exploration or exploitation mentioned in paragraph 2 of the provision. The subparagraph therefore matches the provision in paragraph 2 of Article 13.

198. Subparagraph c) deals with shares or comparable interests that, at any time during the 365 days preceding their alienation, derived more than 50 per cent of their value directly or indirectly from the property mentioned in subparagraphs a) and b). The provision is modelled on the one in paragraph 4 of Article 13, but goes beyond it by allowing the aggregation of the value of the property mentioned in subparagraphs a) and b) when applying the 50 per cent value test. This would allow, for example, the source State to tax the gains from the disposal of shares in a company where 30 per cent of the value was contributed by extraction rights and 30 per cent by a movable rig that was exploiting those rights.

Employment income

199. The provision deals with the taxation only of the enterprise that performs relevant activities. However, provisions in some bilateral treaties also enlarge the taxing right of the source State over income from employment beyond that permitted by Article 15. Article 15 itself would preserve the source State's right to tax a non-resident's employment income in most instances. But where a non-resident employee performed consecutive contracts with different non-resident employers – and the remuneration was not borne by a permanent establishment (including one deemed to exist under paragraph 3 of the provision) – Article 15 would not provide for source State taxation (unless the non-resident employee was present in the source State for a period or periods exceeding 183 days in any twelve-month period commencing or ending in the fiscal year concerned). Depending on the facts and circumstances, the formal contractual relationship between the employee and the employer could be challenged for purposes of determining the “employer” for Article 15 purposes (see paragraphs 8.1 to 8.28 of the Commentary on Article 15), if necessary invoking the principal purposes test in paragraph 9 of Article 29. But if this situation remains a concern, a provision such as the following could be inserted after paragraph 2 of Article 15:

Notwithstanding the preceding provisions of this Article, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State, and connected with relevant activities within the meaning of Article [X] carried on in that other State, may be taxed in that other State if the employment is so exercised for a period or periods exceeding in the aggregate 30 days in any twelve month period commencing or ending in the fiscal year concerned.

200. Under this provision, the State where the employment was exercised could tax the remuneration of a non-resident employee even if the employer did not have a permanent establishment, provided the employment was exercised there for more than 30 days in the relevant twelve month period. But whether or not the provision is used, Article 15 preserves the right of the State where a non-resident's employment is exercised to tax the remuneration in respect of any such employment, regardless of its duration, if the remuneration is borne by a permanent establishment (including one deemed to exist under paragraph 3 of the provision) that the employer has in that State because the condition in subparagraph c) of paragraph 2 of Article 15 is not met.

201. An alternative way of expanding the taxing rights of the source State over employment income would be to amend subparagraph a) of paragraph 2 of Article 15 as follows:

a) *the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days*
(or, where the employment is exercised in connection with relevant activities within the meaning of paragraph 3 of Article [X], 30 days) *in any twelve month period commencing or ending in the fiscal year concerned, and*

Under this approach, the 30-day test refers to days of presence, rather than the period in which the employment is exercised, in line with the way that Article 15 otherwise operates.

202. States contemplating the use of an expanded provision on employment income should recall that, as explained in the Commentary on Article 15, one reason for the general rule in that Article is to avoid taxation of short-term employment contracts in the source State where the employment income is not allowed as a deductible expense in the State of source. States adopting this provision may wish to consider the potential increase in administrative burden where the employer is neither a resident of, nor has a permanent establishment in, that State.