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

"Adeus Conflito, Bemvindo 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The Commissioner is bound by this ruling as stipulated in section 66 of UNTAET Reg. 2000/18, until withdrawn and or amended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The PTA was repealed through and by the Taxes and Duties Act 2008 (TDA) Law No. 8, which

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 Timor[2]. 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 x 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 x 116.5%) – (I x (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 x 116.5%)** of the formula in Section 18.1 is negative for a tax year, the subtraction of component **(I x (1-r))** for that year does not reduce the amount of **((A x 116.5%) – (I x (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;

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(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' 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

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(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**

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The TST between Timor-Leste and Australia became effective in Timor-Leste from 20 May 2002[3]. 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 basis[6].
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)

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(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 TGP 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 3(b)(i), 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, loses 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, loses 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 loses 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 May19, 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.

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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

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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 TGT, 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
DIRECÇÃO GERAL DE RECEITAS E ALFÂNDEGAS
GABINETE DIRECTOR GERAL
Dated this 28th day of June, 2011