Tolerable Taxation for a Tolerable Planet: How to Tax Carbon Credits Generated in Connection with Petroleum E&P Activities in Africa?

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Abstract

Because of the international commitments undertaken by African countries in the framework of the Paris Agreement, the language of petroleum E&P contracts has been evolving to reflect increased concerns with environmental issues, particularly with carbon dioxide emissions of oil operations. Parallel to these changes, International Oil Companies have been looking to Africa to set up carbon credits-generating projects, in view of their pledge to achieve carbon neutrality. The coupling of both developments, notably through a contractual obligation to implement projects of this nature, may thus require a careful review of the applicable tax treatment. Rules on the taxation of carbon credits in African jurisdictions are still in the early implementation stages, being mostly approved in the context of REDD+ legislation. Some local Governments have sought to create taxes specific to carbon credits generation activities, particularly trading activities. However, the articulation between these taxes and the instituted legal framework leaves much room for doubt, as it remains unclear whether these taxes can be cumulated with the applicable income taxation. Adding to an already complex framework, the projects should also be reviewed from the standpoint of petroleum special tax regimes. With respect to income taxation, one should seek to determine: (i) if any income deriving from the operations over carbon credits would be subject to special petroleum taxation rules; and (ii) would costs incurred be deemed deductible for petroleum taxation purposes. On the matter of other taxes, exemptions or special regimes applicable to petroleum operations would also need to be considered as they may, in some cases, apply. Understanding the specificities of the existing legal framework is essential to ensure that investments are correctly modelled, particularly in the context of the negotiation of tax benefits attributable to these projects. Ultimately, States should be mindful of this when constructing regimes that will be used to tax operations over carbon credits and give special attention to the need to ensure the harmonisation between the regimes negotiated on an individual level and to safeguard contractual stability.

Henry David Thoreau said it best, "What is the use of a house if you haven't got a tolerable planet to put it on?".[1] The pursuit of sustainability has been at the forefront of the political agenda for the 21st century. As one of the main contributors to carbon dioxide emissions across the planet, extractive industries and, more particularly, the oil and gas sector have been key targets of the policies forged by States, regulatory bodies and civil society activism.

Throughout the years, these policies have resulted in progressive adaptations being made to the language of the petroleum E&P contracts imbuing them with environmental protection concerns. For most petroleum contracts, this currently means the obligations to conduct environmental impact studies or to comply with international best practices in the petroleum industry to prevent pollution and damages to the environment or even to contribute to environmental risk protection funds, with the level of mitigation measures to be implemented being reliant on subsequent assessments (notwithstanding any applicable law providing for specific obligations). This is the case, for example, of the model Production Sharing Contracts (PSCs) adopted in the Republic of the Congo for the 2016 Licensing Round, or in Equatorial Guinea, as released in 2019.[2]

The increase of the prevalence of underlying environmental concerns has led to these contractual obligations becoming more specific and layered. In this sense, the States' international commitments to reduce global carbon dioxide emissions in the framework of the Paris Agreement greatly contributed to the latest developments in contractual language that are being put in place, evidence of which can be found in Gabon's model PSC[3] for deep and ultra-deep waters, requiring the contractor to file a monthly return on the greenhouse gases emissions produced in each development area. This is the same in other jurisdictions with requirements to implement and develop projects intended to secure a reduction in emissions arising from the petroleum activities.

[1] H. D. Thoreau, *Cape Cod "What is the use of a house if you haven't got a tolerable planet to put it on?"* (Scope Publishing, 2015).
[2] See *https://www.resourcecontracts.org/contract/ocds-591adf-6183523443/view#/pdf.*
[3] See *http://gabon12thround.com/wp-content/uploads/CEPP-Type-zone-offshore-profond-et-tr%C3%A8s-profond.pdf.*

The set-up of this type of project by oil and gas companies is not new. In fact, international oil companies have increasingly committed to achieving carbon neutrality and the sustainability of their operations through the implementation of certain emission reduction projects and are looking to Africa to invest in natural carbon sinks and the generation of carbon credits. Total's investment in a 40,000 hectares reforestation project in the Republic of the Congo, which purpose is to create a carbon sink enabling the sequestration of over 10 million tons of CO_2 for 20 years,[4] or Shell's investment in the Sine-Saloum project in Senegal to regenerate around 4,775 hectares of mangroves as part of the world's largest planned mangrove restoration project and expecting to generate up to 1.7 million credits,[5] are just a couple of recent examples.

That being said, the set-up of such projects in the scope of petroleum operations may lead to specificities in tax treatment, which add to an already complex framework.

General rules on the taxation of the carbon credits

Prior to delving into the specificities of petroleum operations, one would do well to recall the status of the implementation of rules governing the taxation of carbon credits in Sub-Sahara African countries. In a nutshell, such rules are still very insipid and in the early implementation stages, being mostly approved in the context of REDD+ legislation, which is still quite young.

Some governments have sought to create taxes specific to carbon credits generation activities, particularly trading activities, which value-generation potential is quickly escalating. Whilst justly ensuring the State's take on wealth that has been generated in the country, the articulation between these taxes and the instituted legal framework leaves much room for doubt.

Let us take an example. In the Republic of the Congo, both the Forestry Code and the REDD+ legislation, provide that a carbon-credit sales tax should apply over sales of credits by private entities. No reference is included either on the territoriality, the rate or the taxable base of this tax. In other words, for the time being, and until complementing legislation is passed down, this provision can reasonably be seen as ineffective—particularly if one were to consider that the principle of tax legality contained in the Congolese Constitution requires that the law defines the key aspects of the tax. In other words, the lawmaker may not be content with merely creating the vessel of taxation but is required to give such vessel a minimum content.

Notwithstanding our comments—from a strictly technical standpoint—on the ineffectiveness of taxes for which no taxable base is defined, in the absence of any existing guidelines or regulations, all aspects of the relevant regulatory framework should be considered to understand the interaction of these taxes with other existing forms of taxation, notably potential Corporate Income Tax due on income derived from operations over carbon credits. For instance, in the absence of taxable base rules, the ownership of the carbon credits may, in some cases, hint at solutions. Where the property of carbon credits is granted directly and exclusively to the investor, existing carbon credit taxes may create a production sharing allocation mechanism, intended to produce effects similar to the split in ownership between investor and the State. The cumulation of this profit-sharing mechanism with other income taxes would therefore seem possible—at least from a theoretical standpoint. In cases where this split in ownership already exists under the relevant legal framework, the existence of two taxes on revenues deriving from carbon credits may be harder to justify.

These issues, which hinder legal security and the protection of legitimate expectations, are further muddled by the lack of regulation of some key aspects. The absence of clear territoriality provisions establishing the degree of territorial connection that needs to exist for the aforementioned carbon credit-specific taxes to apply, or even the interaction of these taxes with transfer pricing rules when there is a transfer of carbon credits between related parties are sound examples of matters which have not yet been addressed by these tax systems.

On the other hand, indirect taxes (VAT and Registration Duties) may also pose further concerns. By way of illustration, under both the Mozambican VAT Code[6] and the Congolese VAT Law,[7] the transfer of carbon credits would be considered as a supply of services to the extent that these are recorded as intangible assets under accounting rules. However, whether or not VAT would apply would depend on the applicable territoriality rule. For example, a significant number of countries follow the European model in that a service is deemed rendered in country (and thus subject to local VAT) when the service provider (i.e. the seller of the carbon credit) has its head office, permanent establishment or is domiciled in country. Other countries, typically Francophone Africa countries, generally consider that a given service is deemed located in country whenever the right transferred (i.e. the carbon credit) or the good rented is used or operated locally. It may be inferred from the above that the aspects which are crucial to determine VAT subjection of a transfer of carbon credits vary from country to country and need to be ascertained on a case-by-case basis.

As it stands, jurisdictions with immense potential for similar projects, such as the Democratic Republic of the Congo, are hampered due to the lack of sufficient regulation on several tax aspects. The current legal framework applicable to carbon credits, combined with

[4] See *https://totalenergies.com/media/news/press-releases/total-and-frm-to-plant-forest-in-congo*.
[5] See *https://www.shell.com/energy-and-innovation/new-energies/nature-based-solutions.html*.
[6] Law No.32/2007 of 31 December 2007 as amended.
[7] Law No.12-97 of 12 May 1997 as amended.

the absence of guidance from the tax authorities—possibly because the issue is not yet on their radar—fail to equip investors with the levels of legal certainty required for projects of this scale. Consequently, the tax treatment of carbon credits is increasingly reliant on the outcome of negotiations with the Government, which is frequently not empowered to grant deviations to the tax law. In accordance, the language of the corresponding agreements needs to be carefully weighed to secure the desired level of legal certainty and stability without going beyond the Government's constitutional powers, until such a time as complementing regulations are issued. Such regulations, if and when they are drafted, should therefore be mindful of the need to ensure the harmonisation between the regimes negotiated on an individual level and to safeguard contractual stability.

Operations over carbon credits resulting from E&P obligations

Turning now to petroleum E&P contracts, these are typically subject to a specific tax framework, with the force of lex specialis, which prevails over general regulations, and details the particular tax treatment that should apply to petroleum operations. The scope of these rules varies depending on the jurisdiction at stake, and whilst similarities may be drawn among them, notably with respect to income taxation, VAT systems and property tax exemptions, other specificities may also be set out, such as benefits in connection with services rendered by suppliers, benefits in connection with payments to expatriate personnel, among several others. Depending on the existing legal framework, petroleum special tax regimes may be relevant when reviewing the implications of operations over carbon credits arising from projects implemented by mandate of an E&P contract.

From an income tax standpoint, the issue should be reviewed from two perspectives: (i) if any income derives from the operations over such credits, would that income be subject to special petroleum taxation rules; and (ii) would costs incurred be deemed deductible for petroleum taxation purposes.

Compliance with international tax principles would require some level of symmetry, that is to say that the income should be attributed to petroleum operations to the extent that the cost is deemed deductible and vice-versa. From a practical standpoint, asymmetries in the tax treatment of costs and income could result in unfair deviations to the taxpayer capacity principle and also create accounting difficulties.

Taking the example of Company A, which has entered into a PSC with country X imposing a contractual obligation to implement emissions reduction projects. Company A decides to invest in a reforestation initiative generating carbon credits and receives income on the use of such carbon credit (either through its offset against emissions or the sale of the credit). Under the existing legal framework, petroleum operations income is taxed at 20% and income from other activities is taxed at 35%. Assuming that (i) the taxable Petroleum Income amounts to 130M; (ii) the income derived from carbon credits amounts to 50M; and (iii) the costs incurred with the set-up of the emissions reduction project amount to 40M:

- *Scenario A—Carbon credits costs and income are subject to special petroleum operations rules*: In this case, the final tax liability would amount to 28M [(130M+50M-40M) x 20%].
- *Scenario B—Carbon credits costs and income are not subject to special petroleum operations rules*: In this case, the final tax liability would amount to 29,5M [(130M x 20%) + (50M-40M) x 35%].
- *Scenario C—Carbon credits costs are subject to special petroleum operations rules but income is taxed under the general regime*: In this case, the final tax liability would amount to 35,5M [(130M -40) x 20% + 50M x 35%].

Looking at the examples above, Scenario C seems an aberration from a tax standpoint and countries should be mindful of the existing regimes to avoid creating this type of disparity as it may deter investments. Whilst the lawmaker is entitled to decide on imposing higher tax liability on income from carbon credits, it should, in all cases, be aware of applicable legal and tax principles, as such disparities would necessarily have implications in the negotiations of the tax benefits applicable to their E&P contracts.

Adding to the above, asymmetries in a given jurisdiction between the tax treatment of projects developed in the context of an E&P contract and those developed outside its scope could also raise issues of tax equality and be leveraged by International Oil Companies as an instrument of tax planning, particularly considering the lack of regulations on the interplay of this type of taxation with the special taxation rules specifically addressing carbon credits (detailed above).

In the end, tax administrations and investors should be mindful of the way tax legislation and relevant contractual instruments are drafted:

- On the side of costs incurred, the deductibility thereof will ultimately rely on the way deductibility is defined, that is if the law provides for a general deductibility principle or a closed list of deductible costs. Where the law governing the taxation of petroleum operations provides for the deductibility of all costs adequately incurred which are necessary to petroleum operations and which do not qualify as non-deductible, there is clear path to argue for the deduction of the costs incurred with carbon credit producing projects to the extent that the relevant projects were only

implemented as a result of obligations imposed by the E&P contracts. In other words, the implementation of carbon credit producing projects being a condition for the execution of the petroleum contract, the cost must necessarily be incurred in order for the Contractor to be able to extract oil under the relevant contract and obtain the income deriving therefrom. There is thus a clear link between the cost incurred (implementation of projects) and the income obtained (income from the sale of petroleum under the contract).

It is not uncommon for petroleum taxation laws to provide for this type of language. Taking the example of the Angolan Petroleum Taxation Law,[8] the same provides for the deductibility of costs which are deemed indispensable to secure the earnings and revenues subject to Petroleum Income Tax. In a similar manner, the Gabonese Model PSC[9] allows for the recoverability (and ultimately the deduction) of any costs which are justified and needed for the conduction of Petroleum Operations to the extent that these are not expressly forbidden.

Where the deduction of the cost with carbon credits producing projects to income obtained from petroleum activities would be permissible, other aspects of the regime should be explored, including with respect to the apportionment of costs between ring-fenced areas namely whenever the same project is developed for the benefit of obligations contained in multiple contracts, or even with respect to the accounting treatment to be attributed to such cost. These issues should be reviewed from the standpoint of the Financial and Accounting framework applicable to petroleum operations, typically the one contained in the relevant E&P contract.

The above notwithstanding, it is not always the case that the concept of deductible costs laid down in the law is so plastic. Closed lists of deductible costs could very well prevent the deductibility of costs incurred with these projects. For those cases, considering the principle of tax legality often times protected by Constitutional Law, the deduction of the cost with emission reduction projects would be reliant on a law being passed down allowing for such deduction to the petroleum project.

- This is much less straightforward with respect to income derived from operations over carbon credits. In the long run, the qualification of this type of income as petroleum operations income would likewise depend on how the latter is defined under applicable regulations, it being more difficult to draw parallels on this point as a result of a more pronounced disparity between tax systems. Looking at the Angolan, Mozambican and Congolese Petroleum Income Taxation rules, this distinction is quite evident:

Pursuant to the Angolan Petroleum Taxation Law, subject to Petroleum Income Tax those revenues resulting from any transactions or operations performed as a result of an action which is either normal or occasional, basic or merely incidental to petroleum operations, including income from supplementary or incidental activities. As a result, qualifying income deriving from operations over carbon credits as petroleum income, would require an analysis of what should be construed as supplementary of incidental activities.

On the Mozambican front, the Mozambican Petroleum Operations Taxation Law[10] provides for a comprehensive list of the earnings deemed to be attributable to petroleum operations. Among several other items, this list specifies that any amounts obtained as a result of petroleum operations, pertaining to the concession contract shall be subject to petroleum taxation rules. The main issue that arises is therefore whether incidental earnings such as those deriving from the operations over carbon credits could be deemed covered by the applicable definition of petroleum operations.

On the other hand, the Congolese Hydrocarbons Code[11] expressly provides that income from activities carried out in country by petroleum companies in the Republic of the Congo which do not qualify as upstream activities (defined as prospecting, exploration, development and production) are taxable under normal conditions. This provision should nevertheless be coupled with the Financial and Accounting framework applicable to

[8] Law No.13/04 of 24 December 2004 as amended—https://anpg.co.ao/wp-content/uploads/2020/09/Petroleum-Customs-Law-13_04.pdf.
[9] See *http://gabon12thround.com/wp-content/uploads/CEPP-Type-zone-offshore-profond-et-tr%C3%A8s-profond.pdf.*
[10] See *http://www.inp.gov.mz/pt/Politicas-Regime-Legal/Legislacao/Lei-n114-2017-Altera-e-republica-o-Regime-Especifico-de-Tributacoes-e-de-beneficios-Fiscais-das-Operacoes-petroliferas-aprovado-pela-Lei-27-2014.*
[11] See *https://www.hydrocarbures.gouv.cg/_files/ugd/7d7b11_92265118d95946dbaa782261ab6cfdd0.pdf?index=true.*

the petroleum activities, as same sometimes provide for more specific rules on the allocation certain types of revenues or costs to the relevant petroleum accounts.
In all cases where the income deriving from these operations is not attributable to petroleum accounts, certain types of practical difficulties could arise from the need to hold separate accounting balances for Petroleum Operations and other activities carried out in country.

Finally, taxation issues pertaining to carbon credits produced in the context of a petroleum contract are not limited to income taxation. More particularly, there could be other issues stemming from tax benefits or special regimes applying to such petroleum operations, which applicability to emission reduction projects may not be as straightforward. This is the case, for example, of exemptions from registration duties or special VAT regimes. Naturally, applicability of these benefits to emission reduction projects would rely on a combined interpretation of the tax system as a whole. First, because it may be that certain theoretical issues do not arise in practice, as would be the case if VAT were not to apply to a given operation for territoriality reasons. Secondly, because the solution ultimately relies on the language employed and the manner in which the law is drafted. For illustration, the scope of the special VAT regimes applying to petroleum activities, may be defined from a more objective point of view, as would be the case of a rule limiting the special regime to petroleum operations, or, alternatively, from a more subjective point of view, with a rule limiting the special regime to holders of petroleum E&P titles. The applicability of the special regimes in those instances would immensely rely on how the relevant concepts are construed under the country's legal framework and would not necessarily need to be aligned with the income tax treatment detailed above.

Existing legislation across Sub-Saharan Africa on the taxation of carbon credits is still quite young and has for the moment failed to address a number of key issues. As a result, in the absence of specific guidelines, interaction between this legislation and the legislation applicable to the oil sector would still need to be carefully studied to understand the consequences on the recording of income and costs derived from the implementation of emissions reduction projects imposed through an E&P contractual obligation. In all cases, understanding the specificities of the existing legal framework is essential to ensure that investment is correctly modelled, particularly in the context of negotiation of tax benefits attributable to these projects. Ultimately, States should also be mindful of these differences where construing regimes that will be used to tax operations over carbon credits and give special heed to the stability mechanisms and special tax benefits that have in the meantime been negotiated with the Government.