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GETTING THERE FIRST – SEIZING ARGENTINA'S PROMISING FUTURE IN THE UPSTREAM OIL AND GAS INDUSTRIES

Argentina is a major hydrocarbons producer and its potential to increase current production is undeniable. In Argentina there are nineteen sedimentary basins with a total surface of 1,750,000 sq km, at least five of them continue on Argentina's continental shelf, while others continue below the sea. After a decade of market asymmetries, the industry is giving signs of recovery, with projections of production exceeding past averages. Signs of a change in public policy towards the industry as well as positive results from initial off-shore explorations in our country's vast continental shelf are exciting many well established players and newly arrived investor. This document comments on the main aspects related to the tax and legal regulatory issues of the upstream oil and gas industries and provides practical insights based on our experience assisting companies in arranging tax efficient and legally strong oil and gas business in Argentina.

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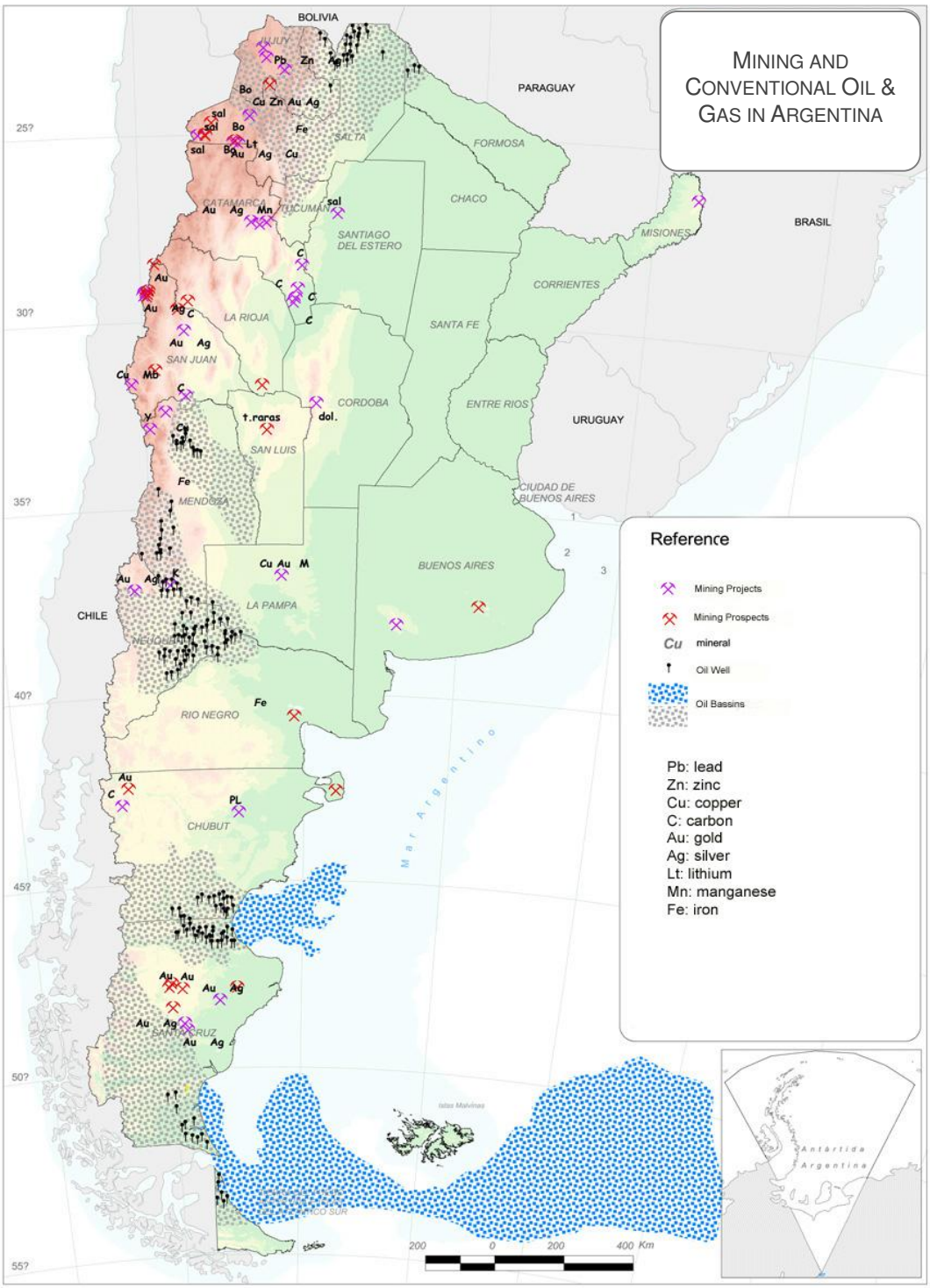
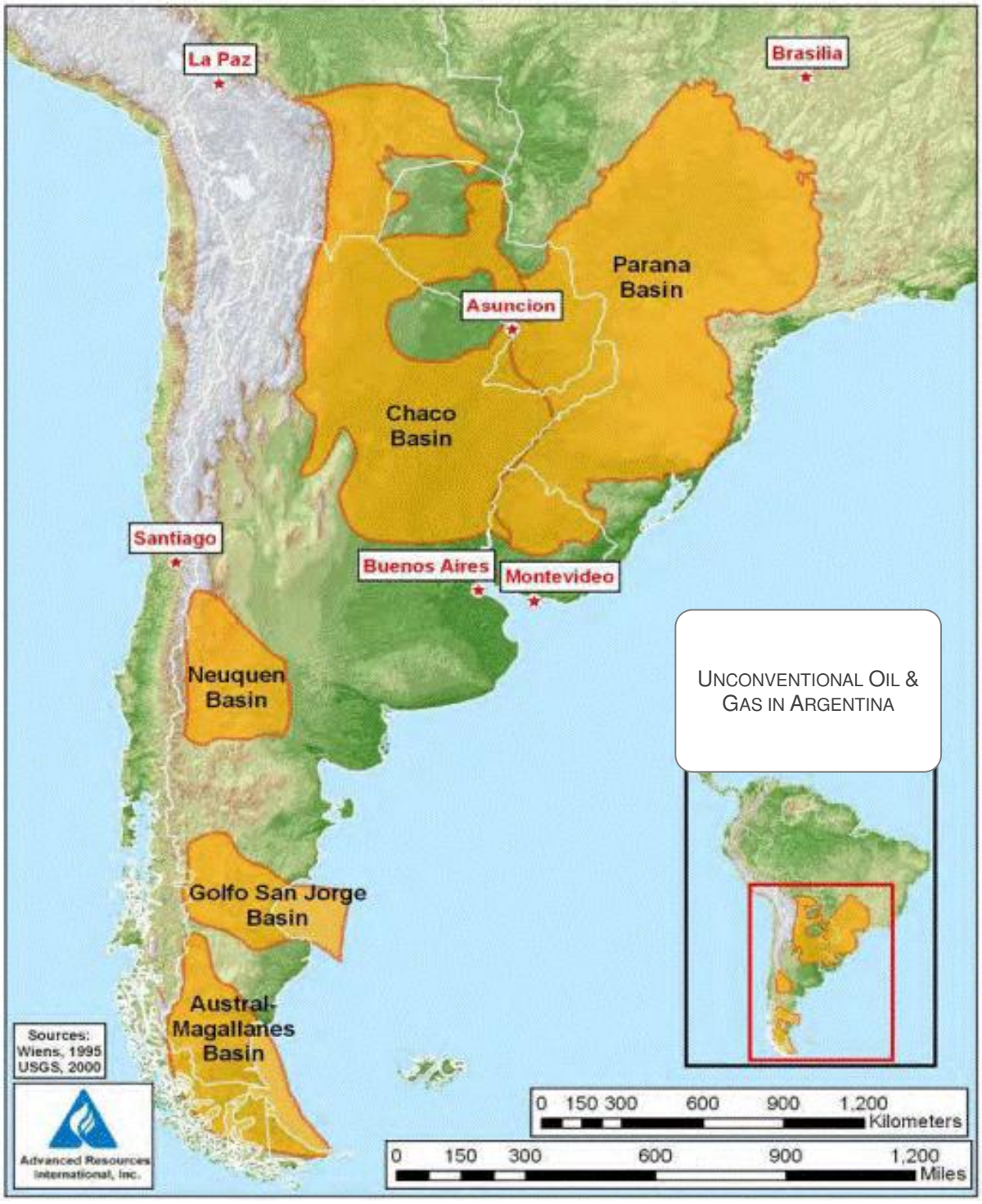
I. INTRODUCTION

Argentina is a major hydrocarbons producer and it has great potential to increase its current production. In Argentina there are nineteen sedimentary basins with a total surface area of 1,750,000 square kilometers, at least five of them continue on Argentina's continental shelf, while others continue below the sea.



It also has great potential in unconventional oil and gas. According to the US Energy Information Administration[1], Argentina has the third largest shale gas reservoir in the world, behind the United States and China, with 774 trillion cubic feet ("Tcf") of technically recoverable shale gas resources.



[1] http://www.eia.gov/todayinenergy/detail.cfm?id=14431

The discovery of unconventional hydrocarbons brought some relief to a country with a growing energy deficit. However, to date, unconventional hydrocarbons remain a largely untapped resource.

Yacimientos Petrolíferos Fiscales S.A. ("YPF"), Argentina's leading energy company, aims to invest more than USD30 billion in the next five years (USD4.5 billion of which is to come from strategic partners) to help pay to develop its huge shale oil and gas resources. In virtue of this, the Argentine Government began talks with international oil & gas companies regarding the exploitation of the discovered deposits. YPF organized joint venture models in the development of these projects.

As a general rule, JOAs is typically used in the upstream sector, where the technical complexity and/or economic exposure necessitates the creation of a joint venture. In general, JVs are in respect of single concessions.[2] Concessions are often held by several parties, which agree to act together in a JV whereby they divide the expenditures as well as the benefits of any petroleum or gas which is produced under the terms of the concession.[3] We note that JVs are contractual rather than legal entities under Argentine law. Each party to a JV is treated individually for tax purposes and they can have different liabilities from each other under different taxes.

This document comments on the main legal considerations for oil and gas exploration and production ("E&P") in Argentina and touches upon the current market developments.

II. CURRENT MARKET DEVELOPMENTS

1. General

In 2012 through Act No. 26,741, the Argentine Government expropriated 51% of YPF's shares that were owned by Spanish based multinational Repsol, taking back the control of the mayor hydrocarbon producer of Argentina in order to achieve the hydrocarbons self-sufficiency, a matter of national public interest and a priority of the state.

After a series of negotiations on March 27, 2014, the Argentine Government and Repsol reached an agreement on the payment of the compensation for the expropriation. The agreement establishes compensation of USD5 billion in public bonds. The agreement was been approved by the Argentine Congress, by the issuance of Act No. 26,932, published in the Federal Official Gazette on April 28, 2014.

The market changes resulting from YPF's expropriation provide opportunities in all levels of the oil and gas sector. At the top end, the market is being re-shaped, with new opportunities for multinational companies to get a greater foothold in the sector. There also appears to be substantial opportunities for juniors and service providers to explore and develop new areas, and to subcontract services which may revive the whole sector.

There is a clear aim of boosting E&P in Vaca Muerta's significant shale oil and gas field, with the door open for foreign investors to partner with YPF and help develop these resources. To that end, in 2014 the Hydrocarbons Act was amended in order to encourage investment and promote funding for the exploitation of unconventional hydrocarbons. This new legislative framework:

- complements the existing legislation and specifically regulates the exploitation of unconventional hydrocarbons;
- provides for a new bidding mechanism for the exploration and exploitation of hydrocarbons and association between private energy companies and public companies;

[2] ROBERTS, Peter, *Joint Operation Agreements: A Practical Guide,* Globe Business Publishing Ltd., 2010, pages 14-15.
[3] *Ibid*, page 16.

- promotes private partnerships that invest in the exploration and exploitation of unconventional hydrocarbons, and avoid the 'carry' practice.
- creates uniform taxation mechanisms regarding hydrocarbon exploitation activities at national, provincial and municipal levels;
- establishes common minimum requirements for the protection of the environment in all regions in view of sustainable exploitation; and
- establishes new limits for exploitation and exploration terms.

2. Shale Oil & Gas – Vaca Muerta

The companies that have already started projects in this area are:

(a) YPF

YFP has launched a shale oil pilot project together with Chevron on the Loma La Lata and Loma Campana deposits. The company has 19 rigs focused on this venture. There are currently more than 300 wells producing unconventional gas and oil in the Vaca Muerta formation. Some 250 are operated by YPF and the rest by foreign oil companies. From January 2013 to mid-2014, daily oil output climbed from 3,000 to 12,000 barrels per day, before jumping to 21,000 in September.

YPF is assessing whether to begin acquiring local sand deposits to produce fractured sand. To that end, company technicians have evaluated in the last months several reservoirs in the country. Today, YPF pays close to USD700 per ton (mt) of fractured sand. The company claims that it can be locally produced for USD 300. To do so, substantial amounts of sand (with a 20/40 and 30/50 composition) would be needed for a refining plant. Each well uses about 600 tons of sand for each fracking stage.

(b) Chevron

In 2015 Chevron expects to test two exploratory wells drilled in the Trapial.

(c) Shell

Shell is exploring three non-conventional projects in the Neuquén basin. The Anglo-Dutch oil company tripled its investment budget to $500 million in 2014. Shell has four producing oil wells on its Sierras Blancas Block.

(d) Pan American Energy

PAE is also looking to increase its presence in Neuquén. The company is close to launching a project of 38 tight gas wells in Lindero Atravezado, the adjoining concession to Loma La Lata. In this initiative will invest more than USD 500 million.

(e) Total

In October 2013, Total Austral, the biggest producer of gas in the Neuquén basin, launched a shale gas pilot project in the Aguada Pichana field. The project will require an investment of USD 300 million and includes the drilling of 12 horizontal wells with a high number of hydraulic fractures (15 to 20 per well).

(f) Petrobras

Petrobras, the third biggest producer of gas in the country, announced in November 2014 a USD 622 million investment in the shale gas production in the Punta Rosada formation.

(g) ExxonMobil

ExxonMobil, the world's biggest private oil company, is the operator of Bajo del Choique block, which produced 770 barrels of oil a day in its first flow test.

(h) Wintershall

In November 2014 the German oil company Wintershall announced the boast of a pilot plan with the Argentina's state-owned Gas y Petroleo de Neuquen to develop unconventional hydrocarbons in the Aguada Federal block. The agreement provides for an overall investment of USD 3.35 billion.

(i) Pluspetrol

Pluspetrol, the fourth biggest producer of oil and gas in Argentina, is scheduled to drill 74 wells during 2014; in line with the estimate of this year that was of 75 wells and also the 82 that were drilled last year. The oil company is also working on the viability of a project that involves drilling fifty gas wells in the Neuquén Basin. This adds to the move of the oil in unconventional fuels, which includes the drilling of 21 wells with an investment of about USD 160 million.

III. REGULATORY LEGAL FRAMEWORK FOR CONVENTIONAL AND UNCONVENTIONAL HYDROCARBONS

The Hydrocarbons Act No. 17,319 provides that the Provinces own the hydrocarbons deposits in their territory, including those at the sea adjacent to its coast up to a distance of twelve (12) nautical miles from the baselines stipulated by law. The Nation owns the deposits located in federal territory and the ones that may be found from twelve (12) nautical miles from the baselines established by law, to the outer limit of the continental shelf.

The Hydrocarbons Act provides the basic regulations for hydrocarbons exploration and production according the following terms:

1. Exploration permits

To develop any type of exploration activities a company requires a permit granted by the provincial or federal authority after a bidding contest is conducted.

One of the main amendments included to Hydrocarbons Act is the movement from the existing varied provincial systems of awarding licenses to a competitive bidding process which is uniform across Argentina, irrespective of the national or provincial authority that is holding the bidding process. Moreover, in order to create a uniform federal regulatory framework, the competent authorities of the federal and provincial governments will collectively draft a model bidding contract. Once the request for tenders is published, each provincial enforcement authority shall draft the specific bidding contract, ensuring the widest publication and seeking the greatest possible audience.

The award of the tender shall be granted to the bidder who submitted the most suitable bid. For its part the national or provincial authority, as appropriate, will evaluate the proposed investments and exploration activities with the power to reject all bids or directly award the tender to the only bidder if only one bidder submitted an offer.

The validity term of the permit is stipulated in the bid and may vary according the exploration target. The new law provides for different time periods of the exploration permits depending whether the exploration is intended for conventional or unconventional hydrocarbons. In the first case, the new Act contemplates a basic term of three years, renewable for a second period of three years.[4] On the other hand, exploration permits for unconventional hydrocarbons are also divided into two periods, but the basic term is set at four years, with the possibility of renewing for another equal term.[5] In both cases, the new system also provides for an additional extension of up to five years, totaling a maximum of eleven years for conventional exploration and thirteen for unconventional licenses. For exploration on the continental shelf and territorial waters each basic term period in connection with conventional exploration purpose may be increased by one year.

Holders of exploration permits are subject to the payment of a surface canon (a periodic payment). The new Act sets out the scale upon which the holder shall pay annually and in advance a fee for each square kilometer, depending on which stage of the concession it is actually in. However the amount to be paid can be subject to adjustment compensating the actual investment in the exploration area.

Finally the restriction which prevented a company form holding more than five exploration permits has been removed.

2. Exploitation concession

If hydrocarbon discoveries are made within the defined area, the holder of an exploration permit has the right to be granted an exploitation concession, thus acquiring the exclusive right to exploit hydrocarbon reservoirs that exist in that area. Concessions can also be granted by the respective authority through a bidding process. Additionally, exploitation concessions grant the right to hold a corresponding transportation license.

Oil production concessions grant the concessionaire the exclusive right to produce oil from the area covered for a period of time that will vary depending on the exploitation method:

(a) *25 years for conventional deposits;*

(b) *35 years for unconventional deposits, which the law terms an "Unconventional Exploitation Concession", and the first five years of the concession may be allocated to a pilot project to determine the commerciality and profitability of the resources; and*

(c) *30 years for offshore deposits.*

These terms can be extended for an additional 10-year term. Furthermore, unconventional concession holders owning an adjacent and pre-existing concession will be entitled to request the unification of both areas as a single unconventional exploitation concession, provided that the geological continuity of both areas is evidenced.

Moreover, the regulation establishes that concessionaires will have the right to request multiple extensions for periods of up to ten years, provided that they have fulfilled their obligations. The application must be submitted no less than one year in advanced upon expiration of the concession term.

[4] Hydrocarbons Act, section 23.
[5] *Ibid.*

The law also provides that transport concessions will be granted and extended by equivalent terms to those provided for concessions linking the same deadlines upon termination. Upon termination terms, facilities will be return to the domain of the national or provincial government as appropriate without any charge.

3. Exploitation of unconventional hydrocarbons

According to the current regulation, exploitation of unconventional hydrocarbons has been defined as *"the extraction of liquid and/or gas hydrocarbons through unconventional stimulating techniques applied to deposits located in shale gas and shale oil geological formations, tight sands, tight gas, tight oil, coal bed methane, and/or characterized, in general, for the presence of low permeability rocks."*

As mentioned before, permits and concessions terms are extended when the target is unconventional hydrocarbons.

It is important to remark that exploitation concessions require the approval by the respective authority of a pilot project to determine the commerciality and profitability of the resources. The pilot project will be carried out during the first five years of the concession.

4. Association of private companies with provincial companies

Apart from boosting the oil market through the standardization of bidding documents, and to attract foreign investors by creating a more competitive environment, one of the objects of the new Act is to finish with the so called "carry system". One of YPF's principle issues was to provide for a uniform bidding process along the country and to limit the role of the intermediary companies created by provincial governments.[6] These companies typically have a participation in each project of not less than 10% without providing any capital.[7]

To that end under the new regime, neither the federal government nor the provinces are allowed to create reserve areas and award them to companies that are controlled by them. They will have to participate in the bidding process provided by the new law. As a result the new law provides that any vacant area, which, prior to the enactment of the new law had been reserved to provincial companies, shall be tendered under participation agreements under which the company may be carried only during the exploration phase. Existing allocations to provincial companies would not be affected.

5. Regulatory obligations for oil and gas companies

According to the regulation, companies have the following obligations:

(a) *Monthly payment of canon during the exploration permit according the extension of the area;*

(b) *Monthly payment of royalty (percentage over the price of extracted crude oil) during the exploitation concession;*

[6] El Cronista Newspaper: "El Gobierno estudia limitar el control de las provincias sobre el petróleo", April 29, 2014. Available at: http://www.cronista.com/economiapolitica/El-Gobierno-estudia-limitar-el-control-de-las-provincias-sobre-el-petroleo-20140429-0081.html.

[7] El Cronista Newspaper: "El Galuccio cree que el control provincial del petróleo limita las inversiones", May 22, 2014. Available at: http://www.cronista.com/economiapolitica/Galuccio-cree-que-el-control-provincial-del-petroleo-limita-las-inversiones-20140522-0083.html.

(c) *Execution of the investment plan submitted to the respective authority;*

(d) *Compliance with national and provincial environmental regulation;*

(e) *Enrollment with the Federal Register of Oil and Gas Companies; and*

(f) *Comply with information requirements from the respective authority.*

If the concessionaire fails to: (i) pay the canon during one year; or (ii) pay the royalties during three months; or (iii) comply with investment plan or other relevant obligations, the respective authority is empowered to terminate the concession and revert the areas to the province or Nation.

IV. ENVIRONMENTAL MATTERS

Section 41 of the Argentine Constitution provides that all inhabitants are entitled to the right to a healthy and balanced environment fit for human development so that productive activities shall meet present needs without endangering those of future generations; and shall have the duty to preserve it. As a first priority, environmental damage shall bring about the obligation to repair it according to law. This principle was enshrined by the General Environment Act No. 25,675.

As a general rule, in every jurisdiction, whether federal or provincial, Environmental Impact Assessments must be approved for all new projects and periodically updated. In addition to general approvals, certain activities require specific permits particularly those that concern emissions, effluents and waste.

Companies engaged in the upstream hydrocarbons industry also have to comply not only with the general environmental framework but also with the technical regulation applicable to their industry that is enforced by each province.

The general obligations on oil and gas companies are the following:

- Perform exploration and exploitation activities using the most efficient techniques in line with the nature and magnitude of probable reserves, while ensuring maximum production of hydrocarbons with adequate exploitation of the deposit;
- Take all necessary measures to prevent damage to the oilfield during drilling, operation, maintenance or abandonment of wells;
- Avoid any waste of hydrocarbons;
- Take safety measures recommended by the accepted practices in the industry in order to avoid accidents of all kinds;
- Take the necessary measures to prevent or reduce damage to agricultural activities, fisheries and communications, as well as the reserves of water that may be found while drilling activities are performed;
- Take the necessary precautions to avoid contamination of waters and adjoining shorelines, when working adjacent to such areas.

Compliance with environmental obligations is essential for the longevity of a project. Enforcement authorities have the power to impose penalties ranging from a pecuniary fine through to closing down a project. It is also noteworthy that penalties are imposed not only on companies but also on directors and relevant personnel in charge of environmental matters.

The Argentine Office of the Environment and Sustainable Development is the highest authority in Argentina, however, there are also provincial and municipal authorities charged with specific responsibilities to ensure environmental protection. The appropriate authorities relevant to a project must

be determined on a case-by-case basis, having regard to both the location of the project and the activities it performs which affect the environment.

V. TAX FRAMEWORK

1. Tax structures and incentives

The Hydrocabons Act provides a specific tax legal framework for E&P all over Argentina, which is complemented with the Federal Hydrocarbon Agreement, different incentive programs and the general tax regulations provided for the national, provincial and municipal level.

(a) Hydrocabons Act

For exploration and exploitation concessions, concessionaires are required to pay to the pertinent provincial authorities: (i) royalties –at a 15% and 12% rate from the well-head value respectively– which may be paid in kind if so required by the pertinent provincial government;[8] and (ii) an annual surface canon based on the surface area of the concession or permit.

Section 56 of the Hydrocabons Act provides that:

- Permit-holders and concessionaries would be subject to the payment of all provincial and municipal taxes existing at the date of issuance of the permits and concessions. During the term of permits and concessions, provinces and municipalities would not tax these holders with new taxes or increase existing ones, except the remuneration rates for services and contributions for improvements or general tax increases;

- At the national level, permit-holders and concessionaries would be subject to the payment of customs duties, taxes levied on goods imported into the country and foreign exchange fees. They are also liable to pay the fee established by Sections 57 and 58,9 and the royalties set out in sections 21 and 59 of the Hydrocabons Act, and the obligations referred to in section 64; and

- Section 56(c) of the Hydrocabons Act provides that the net income obtained in the exercise of their activity as permit-holders or concessionaires would be subject to a special income tax. Notwithstanding the foregoing, such net income would be settled in accordance with the general income tax principles stated on the Income Tax Act.

Permit-holders or concessionaires would be exempt from payment of all other national taxes, present or future, of any kind, including the taxes that may apply to shareholders or other direct beneficiaries of the income associated with the activity.

Act No. 27,007 created a promotional scheme for investments in hydrocarbons exploitation and partially modified the tax benefit program. Under it, the companies that invest more than US$250 million over a three-year period will be allowed to sell their production on international markets without paying export taxes[10] and with no restrictions on the repatriation of profits and the importation of capital goods.[11]

These benefits will be claimable as from the third year after the execution of the project, and will apply on the following percentages:

[8] In this case, some provinces have also issued regulations on royalties which contradict the terms of the Hydrocabons Act.

[9] An annual surface canon based on the surface area of the concession or permit.

[10] Act 27,007, Section 19.

[11] *Ibid*, Section 22.

- Conventional exploitation: 20%.
- Unconventional exploitation: 20%.
- Offshore drilling exploitation: 60%.

Decrees numbered 1055/1989, 1212/1989 and 1589/1989 concerning the privatization and deregulation of the oil sector in Argentina partially modified the tax benefit program, implementing a protection with respect to any tax assessment or charges that may be considered discriminatory against the permit-holder or concessionaire. This tacitly repealed the special tax on income provided for in Act no. 17,319, meaning that the general provisions of Income Tax would apply to this type of activity.

However, the system established in 1967 by Act no. 17,319 was not repealed, but never implemented in its entirety. So it is basically partially effective.

(b) Federal Hydrocarbon Agreement

By the Federal Hydrocarbon Agreement, signed in 1994 between the National Government and the governors of the participating provinces, and the Fiscal Agreement between the National Government and the oil-producing provinces, the signatories agreed not to increase the tax burden applicable to permit-holders, concessionaires and other holders of exploitation rights.

The Supreme Court in the case of *Apache Energía Argentina SRL*[12] determined the enforceability of these agreements for signatories who have ratified them by a provincial law, as in the case of the Province of Rio Negro. However, we note that certain provinces, such as Mendoza, have not ratified these agreements by the issuance of a law, so they could not be validly enforced against those provinces.

(c) Oil Plus & Refining Plus Programs

The 'Oil Plus and Refining Plus' Programs were created by Decree No. 2014/08 and regulated by Resolution No. 1312/08 issued by the Argentine Secretariat of Energy, among others. These programs were created to promote investment in oil production and refining. The incentives of the programs are actually effective by means of transferable Tax Credit Certificates, which may be used to pay export duties.

Additionally, Decree No. 2014/08 provides that infrastructure works performed for the exploration and exploitation of new oil fields, and the increase of the production capacity and the incorporation of new technologies for the exploitation and development of existing oil fields that increase their current capacity may qualify as "*critical infrastructure works"* subject to the benefits provided by Act No. 26,360, as described below.

(d) Capital and Infrastructure Investments – Promotional Program

Act No. 26,360 sets forth a temporary program for taxpayers who invest in capital assets for industrial purposes as well as in infrastructure works. Under this promotional program, infrastructure works are defined as all work whose main objective is the performance of productive activities or when its performance is declared to be a critical infrastructure work by the Federal Planning Ministry provided that it involves certain activities, such as the production, distribution and transportation of hydrocarbons.

[12] "Apache Energía Argentina SRL c/ Provincia de Río Negro", *Fallos*: 332:640, March 26, 2009.

The promotional system may be joined by individuals and legal entities that develop productive activities in Argentina which evidence, by means of an affidavit filed with the enforcement authority, the existence of an investment project in industrial activities or an infrastructure work to be carried out between October 1, 2007 and December 31, 2015.

The interested parties will be entitled to the following tax benefits, which are granted through calls made from time to time:

- Advanced reimbursement of Value Added Tax ("VAT") paid for the acquisition, manufacture, production or definite import of capital assets or for the performance of an infrastructure work of the relevant project; or
- Accelerated depreciation for Income Tax purposes.

Both benefits are mutually exclusive. However, they may be applicable together in the case of investment projects destined to the external market or that comprise a clean production or a sustainable industrial reconversion plan, duly approved by the Environment and Sustainable Development Office of the Cabinet of Ministries.

Provinces and the City of Buenos Aires are invited to join the promotion system and exempt, in whole or in part, the sale of the assets included in this system from local taxes.

(e) Gas Plus Program

Created by Resolution No. 24/08 of the Argentine Secretary of Energy, the 'Gas Plus' program gives companies a financial incentive to explore for natural gas by allowing them to charge higher rates for natural gas from new discoveries, i.e., reducing re-sale restrictions for eligible companies.

Due to the 'Gas Plus' program, Argentina became the first country in South America to apply new technology in finding unconventional gas. Moreover, shale gas production is expected to grow and such growth may create opportunities for new investments in Argentine gas areas, particularly for service companies with shale gas know-how.[13]

2. Applicable National Taxes

Argentina has three different levels of taxation, namely, federal, provincial and municipal.

The main federal taxes are income tax, value added tax, minimum presumed income tax, personal assets tax and debits and credits tax.

At the provincial level, the main taxes are the gross receipts and stamp taxes. With respect to municipal fees, there are several fees, including public lighting and advertisement fees, but the most important fee is for health and safety.

Additionally, the provincial and the federal governments are entitled to impose royalties on hydrocarbon activities in their territories. Please note that the Supreme Court concluded that the royalty is not a tax.[14] Notwithstanding this, it is included in this section, in order to maintain the systematic order of the proposed analysis.

[13] Latin American Law & Business Report, *Latin American Energy Markets for 2011 − Argentina and Peru*, Volume 19, Number 3, March 2011.
[14] "*Neuquén Province v. Capex SA / royalty-fee"* (Fallos: 330:2470), December 11, 2007.

At the national level, oil and gas upstream is subject to the following taxes:

- Income Tax;
- Value Added Tax;
- Minimum Presumed Income Tax;
- Tax on bank debits and credits; and
- Export duties.

It is also subject to comply with withholdings requirements in respect of some of these taxes.

(a) Income Tax

As was mentioned above, the special income tax provided for in section 56(c) of Act no. 17,319 was never applied. The activity is governed by the general rules of Income Tax. Accordingly, companies incorporated in Argentina, as well as branches or other permanent establishments in Argentina belonging to foreign companies or individuals are subject to taxation of 35% over their net income. These companies are subject to taxation over their total income obtained in Argentina or abroad, with a set-off applicable in respect of amounts paid abroad for similar taxes on their activities performed outside Argentina, up to the limit of the increase of the fiscal obligation that arises from including the income obtained abroad into their Argentine tax return.

Expenses incurred in order to obtain, maintain and preserve the income levied by this tax are deductible when determining the income tax. There are limitations for certain expenses. If those expenses exceed the income obtained in a given fiscal year, the losses (tax losses) may be carried forward and offset against the income obtained in the following five fiscal years.

Argentine-sourced income obtained by foreign residents is levied with income tax on a withholding basis. Consequently, when a payment for work subject to income tax is performed for a foreign beneficiary, the local payer must withhold the 35% of the net income as unique and definite income tax payment. Income Tax Act sets out presumptions of net income (without admitting evidence to the contrary), at different rates according the nature of the payment made to a foreign beneficiary.

Income obtained from the export of goods produced, manufactured or purchased in Argentina is considered in the aggregate Argentine source income for the exporter. In turn, the income obtained by foreign exporters from the mere incorporation of their products in Argentina is considered foreign source income, not subject to income tax in Argentina.

Within the general tax system, there are some pertinent regulations. Specifically, Section 75 of the Income Tax Act provides:

"The tax value of mines, quarries, forests and similar goods is given by the portion of cost attributable to them, plus, any costs incurred in obtaining the concession. When the proceeds from the exploitation of such assets involves the consumption of the substance which produces the income, the proportion of the substance expended shall be deductible from the income..."

Section 87 of the Regulatory Decree of the Income Tax Act sets out how to calculate the annual tax depreciation to offset the depletion of the income-producing assets. General Resolution of the Federal Tax Administration ("FTA") No. 2165/1979 and the Note DGI No. 1079/1979 complements this specific regulation.

One of the significant distortions in the income tax system is the amortization of goods, that should be done in a linear manner, allowing the deduction in equal installments typically over 5, 10, 15, 20, 33 or 50

years, according the estimated duration of the good. That is, the deduction allowed from the financial point of view is insufficient to cover the initial cost of investments on E&P, taking into account the relevant interests of the delay on performing the deduction.

As was previously noted, JVs are not corporate entities under Argentine law, but contractual, so as not expressly identified as subject for this tax under the Income Tax Act, each of the members of these consortiums must determine their own income tax.[15] In fact, JVs are only considered taxpayers on the Value Added Tax.

(i) Abandonment of oil wells – Deduction of related expenses

Act no. 17,319, Decree-Act No. 33,598 and Resolution no. 5/1996 of the Argentine Secretary of Energy provide the procedure to follow for the abandonment of oil wells. This abandonment involves certain obligations of environmental remediation, all of which will involve expenses for the operator of the site.

The treatment of this expenses is a controversial issue, not only for the interpretation of the accrual principal for income tax but also because of the different interpretations adopted by the FTA, court precedents and taxpayers in calculating these amounts across the exploitation term.

The FTA's reasons for refusing the deduction of expenses not actually incurred could be based on the fact that the quantum of the expenses are not known; they lack supporting evidence; the substantial transaction giving rise to the expense has not yet occurred; there is no obligation to make an accurate and certain payment, so the mere expectation of unpaid debts should be considered losses only when they are incurred, among others.

The Supreme Court in "Astra CAPSA"[16] confirmed some aspects of the position of the FTA. In this case, the court held that the deducted expenses were not extraordinary losses under section 82(c) of the Income Tax Act, but rather regular losses deductible under the regular amortization system, and consequently it is not applicable to the deduction of expenses derived from the exploitation of an oil well, as the expenses related to the burning of the well.

The Supreme Court stated that the deduction of extraordinary losses is held on specific situations that technically are not "necessary expenses", regarding the loss of the source of income. Necessary expenses (as in this case the expenses related to the oil well burning) should be deducted under section 17 of the Income Tax Act.

There are two different treatments applicable to the expenses related to the abandonment of oil wells, the applicability of each depends on the possibility of exploitation of the relevant oil well. In case of the impossibility of exploitation of an oil well, according to Note 1079 and regulation 2165 of the FTA, the expenses related to the study, discovery and/or exploration should be deducted as losses in the same fiscal year of the abandonment of the well. On the other hand, in the precedent mentioned there were not guidelines regarding the possibility to deduct an accrued expense related to well exploitation (e.g. the abandonment of an exploited oil well).

In the case "Jota K S.R.L."[17], the Federal Tax Court details the correct approach. The majority decision, in this case, agreed that accounting provisions made by the appellant were instrumented and are admitted because it is an inherent cost to the business and were deductible in accordance with section 87 (a) of the Income Tax Act.

[15] In this regard FTA Opinion No. 16/2004.
[16] "Astra CAPSA (TF 19.173-I) c/ DGI", *Fallos* 334:53, March 2, 2011.
[17] Federal Tax Court, Room "D", October 8, 2009.

Notwithstanding this, in the case "Enap Sipetrol Argentina S.A."[18], in which the taxpayer deducted these expenses for the remainder of the exploitation term, the Federal Tax Court confirmed the FTA criteria that the deduction was not authorized under the applicable rules, and exceeded the amount attributable to that tax period.

To date there has been no final decision of the Supreme Court on this particular matter.

(ii) Dividends

By means of the last amendment to the Income Tax Act[19], distributions of dividends or profits by Argentine companies are subject to an income tax withholding at a rate of 10% over the total amount of the dividends or profits paid or distributed. If the amount of distributed dividend exceeds the accumulated earnings at the end of the fiscal year before the date of payment, a 35% income tax withholding is also applied on the exceeding amount (i.e., 10% rate over the total amount, and a 35% over the net profits of the exceeding amount).

Dividends remittances abroad must be carried in accordance to the Argentine Central Bank regulations. In this regard, there is no legal restriction to perform such remittances other than (i) evidencing that they derive from closed and audited financial statements, and (ii) an approved Advanced Return of Payments Abroad ("ARPA"), as determined by the Federal Tax Administration ("FTA") Resolution No. 3417/2012.

Under the ARPA certain information must be submitted electronically through the FTA's website. Once the return is approved, the return ID should be informed to the bank through which the remittance of the dividends would be performed.

However, it should be noted that certain non regulated restrictions are currently applied, by which any transaction must be, in practice, approved in advance by the Argentine Central Bank, but not being this prior approval a legal requirement.

(b) Value Added Tax ("VAT")

This tax is levied on all different stages of domestic trade, production and import of movable goods, and a wide range of services. The general tax rate is 21%. A differential tax rate of 10.5% or 27% may apply for certain specific cases.

Every time taxpayers supply services or commercialize any levied products, they collect VAT, at the corresponding tax rate, over the net value of the services or the products supplied or sold. The amount collected as VAT is considered a tax debit that can be offset against the tax credits from the same fiscal period, assessed on a monthly calendar basis, arising from the VAT paid for levied transactions. The balance, if any, shall be paid to the FTA. VAT fiscal credits can be carried over indefinitely.

Hydrocarbon exploration projects are generally slow to mature, which may be capable of commercial exploitation several years after starting. This means that during the period in which production is not obtained to start the extraction stage conditions of merchantability, VAT tax credits may not be charged against tax debts arising from the commercialization of production. Only those companies that are developing and manufacturing operations and generating tax debits would be able to rapidly recover tax; not so, new businesses or corporate groups formed only for the purposes of a particular project.

[18] Federal Tax Court, Room "D", April 19, 2011.
[19] Act No. 26.893, published on the Federal Official Gazette, September 23, 2013.

Upstream oil and gas is generally conducted by corporations working together as part of a JV. Section 4 of the VAT and sections 15 and 15.1 of its Regulatory Decree No. 692/1998 provide that the JV itself is responsible for VAT payments rather than its individual constituents.

There are different positions for the treatment of tax credits accumulated during the exploration activity:

- The monthly transfer of the tax credit from the operator of the JV to the partners, by notes of assignment of expenses;
- Transmission to partners when returning the area;
- Tax credits cannot be transferred to shareholders, the JV must bear that cost.

It is noted that is a common practice in the industry for JV's to assign the corresponding tax credit to companies that are parties to the JV's through notes of assignment of expenses, which reflect the proportion to their interest in the project, i.e. assuming the position stated in (i) above.

Furthermore, tax credits accumulated during the production activity are also usually transferred from the operator of the JV to the companies' parties through notes of assignment of production, which reflect the amount of hydrocarbons corresponding to each member in proportion to their interest in the total production extracted. The total amount expressed is the amount corresponding to the VAT apportioned to each part.

Currently, there are no relevant administrative or judicial precedents which may prevent the use of notes of assignment to transfer tax credit from JV's to the partners. Moreover, it has been accepted in certain non-binding opinions issued by the FTA[20] and other federal authorities.

(c) Minimum Presumed Income Tax ("MPIT")

MPIT is levied on the value of assets of companies located in Argentina and abroad at the end of each fiscal year. The term "assets" includes acquired or manufactured goods, movable assets, real estate, inventories, credits and bank deposits. The effective tax rate is 1% and the taxable base is represented by the value of the assets in excess of AR$ 200,000. Companies whose total assets value is less than AR$200,000 (two hundred thousand Argentine Pesos) are not levied.

The income tax paid in a given fiscal year can be offset against the resulting MPIT of the same fiscal year. If the income tax exceeds the MPIT, the excess is not refundable to the taxpayer. If the MPIT exceeds the income tax, the excess can be carried forward to the following ten fiscal years to be offset against the income tax.

On the contrary, if as a consequence of the fact that the income tax computable as payment on account of the tax under analysis is not sufficient, the payment of the MPIT is applicable in a given fiscal year, the MPIT paid will be allowed to be computed as a payment.

Section 12(b) of the MPIT Act establishes what will not be computable for the tax base *"... the value of first use depreciable property, except automobiles, in the year of acquisition or investment, and the next ..."* (subparagraph a) and *"... the value of investments in the construction of new buildings or improvements... in the year in which the total investment is made or, if partial, and the next ..."*

[20] In this regard, FTA Opinion No. 56/08 (DAT), May 30, 2008, and, as therein quoted, a Memorandum of the National Tax Directorate.

(d) Tax on bank debits and credits

This tax applies to (i) all credits and debits made in any bank account, whatever their nature may be, opened with Argentine financial entities, (ii) all transactions carried out by Argentine financial entities, the beneficiaries of which do not use bank accounts, irrespective of the type of transaction, and (iii) all own or third party funds movements, even in cash, that any individual or entity makes on its own account or on account and/or in the name of a third party, by any means. These types of movements are those made through organized payment systems that substitute the use of bank accounts.

The general tax rate is 0.6% for credits and 0.6% for debits. In the cases set forth in (ii) and (iii) above, the rate is 1.2%, except for certain specific cases. 34% (17% if the tax rate is 1.2% instead of 0.6%) of the tax on credits can be considered as a credit against the income tax and/or minimum presumed income tax and the rest is deductible for income tax purposes.

(e) Export duties

Duties of taxes on the export of oil were introduced in February 2002[21]. Initially this export duty was fixed at a rate of 25%. In August 2004, the Ministry of Economy and Public Finance ("MEPF") issued Resolution No. 532/2004, which established an additional rate to the export duty when the price of West Texas Intermediate ("WTI") barrel was more than US$32.

However, by means of Resolution No. 394/2007, the MEPF repealed Resolution No. 532/2004 and modified the export duties. Resolution No. 394/2007 now provides that when the international price equals or exceeds the reference value indicated in the Resolution for those hydrocarbons, the export duties shall be determined on the basis of the following formula:

$$d = \frac{Pi - VC}{VC} \%100$$

d: Export Duty / Pi = International Price / VC = Cut-off Value

Please note that if the International Price falls below the reference value indicated in the above mentioned Resolution, a 45% rate applies.

However, pursuant Resolution No. 803/2014, the export duties applicable to crude oil and lubricants were reduced. Thus, the following rates apply on those exports:

Regarding gas, Resolution No. 127/2008 established that export duties must be calculated on the basis of the same formula than hydrocarbon exports, mandating a valuation basis for the calculation of the duty as the highest price established in any contract of any Argentine importer for the import of gas. However, if the International Price falls below the reference value set in Resolution No. 60/2015, export duties will be reduced to 1%.

3. Provincial Level

At the provincial level, the activity is affected by the following taxes:

- Gross Receipt Tax

[21] Decree No. 310 (Official Gazette of 14/02/2002), Decree No. 809 (Official Gazette of 13/05/2002), Decree No. 645 (Official Gazette of 26.05.2004) and its complementary and amendments.

- Stamp Tax

In accordance with the Supreme Court decision in "Apache Energy Argentina SRL" (*Fallos* 332:640, above mentioned), the provinces must comply with the provisions of the Federal Hydrocarbons Agreement, which confirms section 56(a) of the Hydrocabons Act, by which they are not entitled to burden permittees or concessionaires with new taxes or increase existing ones, except the remuneration rates for services and contributions for improvements or general tax increases.

(a) Gross Receipt Tax

This provincial tax is levied on the gross income arising from primary activities, manufacturing activities, business and services carried out within the respective provincial jurisdictions. In general, no deductions are allowed over the taxable base, except for the amounts corresponding to (i) refunds, rebates and discounts, (ii) bad debts, (iii) packages and goods returned by the purchaser, and (iv) VAT debits. This tax can be deducted for the purpose of assessing income tax.

Each province has the authority to set the rate it considers appropriate. On "extraction" of hydrocarbons activity, in general, the tax rates range from 1.5 to 3.5%. If activities take place in two or more jurisdictions, it is necessary to follow the Multilateral Tax-Sharing Agreement (*Convenio Multilateral*) to apportion the corresponding revenue to each relevant jurisdiction. Expenses incurred in a given jurisdiction must also be considered for assessing the tax, even when no income is obtained in such jurisdiction.

The problems that can arise with respect to this tax-sharing agreement are on the distribution of the taxable basis when the activity is carried out in more than one jurisdiction (e.g., extraction and commercialization dissociated into two different jurisdictions) and on the determination of the coefficients for this purpose. But this is not a problematic of E&P activity in particular, but overall of this tax.

(b) Stamp Tax

This tax is imposed on instruments or documents that evidence acts or a business made for consideration in the Argentine provinces or the City of Buenos Aires. The existence of the document itself is the taxable event and not the fulfillment of the transaction stated in it.

The tax rate depends on the act instrumented and the Province where it is performed or has effects. In general, tax rates range between 0.5% and 3%.

It should be highlighted that this tax can be lawfully avoided through the execution of agreements under an offer letter accepted by performance.

4. Royalties

Section 59 of Hydrocarbons Act provides that concessionaires must pay a monthly royalty on the well mouth value at a rate of twelve percent (12%). The Hydrocarbons Act allows 3% increase in royalty payments for concession extensions to a maximum of eighteen percent (18%). [22]

It is noted that the government may reduce this in the following situations (i) to a five percent (5%) rate, taking into account productivity, condition and the location of wells, (ii) to twenty five percent (25%) of the applicable royalty, to promote unconventional production, and, (iii) up to 50% if requested by

[22] Hydrocarbons Act, Section 59.

concessionaires for tertiary production, extra-heavy oil and offshore projects.[23] Finally, no royalties should be levied on the oil used by the permittees or concessionaires on the needs of exploration or exploitation.
It worth mentioning that, according to section 97 of Hydrocarbons Act, the Federal Energy Administration has been designated as the implementing authority. Thus, the obligation to pay royalties is to the Federal Government, notwithstanding that it is a provincial resource. Provinces are not entitled to claim the royalty payments or even to make estimates or assessments of the amounts payable.

As above mentioned, the government could reduce royalty payments, in order to promote investments in its territory. Consequently, the Province of Chubut created a new promotional scheme for the holders of a concession that increase their monthly production.[24]

The benefiters of this promotional scheme will enjoy the following refunds over the amounts paid in concept of royalties and the Hydrocarbon Compensation Bonus for Sustainable Development[25] on the production increase:

i. The Province of Chubut will pay to the hydrocarbons concessionaires an amount equivalent to 50% of the royalties and Compensation Bonus when the international price of crude oil is less than USD50.

ii. The Province of Chubut will pay to the hydrocarbons concessionaires an amount equivalent to 33.32% of the royalties and Compensation Bonus when the international price of crude oil is between USD50 and USD55.

iii. The Province of Chubut will pay to the hydrocarbons concessionaires an amount equivalent to 16.67% of the royalties and Compensation Bonus when the international price of crude oil is between USD55 and USD60.

It is noted that, according to Decree No. 71/2015, the value of the international price for reference will be determined not using the price of the WTI barrel, but the price of the Brent barrel.

This promotional scheme will be in force until June 30, 2015. However, it could be extended, depending on the economical situation of the hydrocarbon sector.

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If you have any question or comment regarding the foregoing, do not hesitate to contact us by calling at (54-11) 4326-7386, via fax to (54-11) 4326-7396 or via e-mail addressed to godoy@berettagodoy.com.

[23] New Hydrocarbons Act, Section 6.
[24] Decree No. 71/201524 of the Province of Chubut.
[25] It is an extra royalty paid by the holders of a concession when an extension is requested. The payment base is the wellhead price, and the applicable rates vary from 3% to 4%, depending on the kind of concession, the productivity and life duration of the well.