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### TAXING AS JOINT VENTURE OR PARTNER?

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#### Abstract:

The Petroleum Income Tax Act of 1967 (PITA) is a reference point for taxation during the implementation of the Production Sharing Contract regime in Malaysia. The term *person* under the purview of the PITA encompasses partnerships, which, includes joint venture. The present study aims to elucidate the intricate interplay of relationships and transactions within a joint venture, with a specific focus on comprehending the underlying rationale for considering the entire joint venture as the chargeable person under the PITA, as opposed to taxing individual partners separately. The methodology is based on Research Onion Framework with qualitative research and inductive approach leveraging on action research. Analysing literature review to delve into the structural of the joint ventures and the preparatory measures aimed at ensuring the equitable participation of the involved parties in the joint venture arrangement, particularly in managing various alternative activities that may arise alongside the primary Joint Operating Agreement (JOA) activities, often manifesting as sole risk projects. The engagement in various non-monetary activities and the collective contributions of all partners, particularly in mitigating risks and ensuring the success of upstream exploration and production, are regarded as contributions that may not lend themselves to a straightforward division, which support the joint ventures as a *chargeable person*. The outcomes derived from this methodological approach culminate in a model that elucidates the rationale for taxing joint ventures as opposed to individual partners within the joint venture. This clarification is essential for all involved parties, including taxation agencies, industry stakeholders, and policymakers. Novelty: The study represents an initiative within Malaysia, to explore the interpretation of the PITA. The motivation was sparked by inquiries from industry stakeholders, who expressed apprehensions regarding

the tax assessment processes, whether in the context of joint ventures or individual taxpayers.

**Keywords:**

PITA, PSC, Chargeable Person, Joint Venture, Sole Cost, Selling Price.

**Introduction**

The primary objective of this study is to address and rectify existing ambiguities surrounding the proper reporting of tax computations for a chargeable person (CP) under the Petroleum Income Tax Act of 1967 (PITA). This paper aims to provide clarity regarding the use of the term 'person' to be subjected to taxation, particularly in the context of a joint venture (JV). It focuses on fostering a comprehensive understanding of how CP is identified and assessed in the context of partnership, while also exploring the potential disparities between PITA and the Income Tax Act of 1967 (CITA). The paper draws significantly from a thorough review of existing literature to comprehend the functions undertaken and the risks assumed by partners within the framework of a Joint Operating Agreement (JOA). This is particularly relevant as numerous companies execute their exploration and production activities as part of a consortium or group of companies. Understanding how these functions and risks align with the concept of a JV, as opposed to individual entities, is a critical aspect of this investigation. Based on literature reviews with addition to action research, incorporating focus group as a methodological approach to gather insights and collective perspectives on the identified issues and potential solutions. The inclusion of this focus group enhances the depth of understanding and provides a more comprehensive perspective on how best to structure the taxation of chargeable persons within the complex and dynamic context of joint ventures in the petroleum industry. The paper examined the legislative intentions outlined in the PITA and the CITA concerning the determination of taxable entities within both Acts to explore potential distinctions between the tax treatment of partnerships and JVs. The UK's background on petroleum taxation was also referred. In paragraph three, an overview of the production sharing contract (PSC) regime, shedding light on its common usage and the underlying rationales for its adoption, particularly in the context of JV. Subsequently, we will outline the research methodology employed in this study and present the findings. Finally, in the concluding section, presentation of summary key insights and implications derived from the analysis.

**Legislation**

Critics argue that the UK's fiscal approach to the oil and gas industry was a policy failure due to its non-proprietary stance on these resources. A review of the UK's petroleum fiscal regime reveals that the government attempted to boost fiscal revenues from oil until 1982 but subsequently relaxed regulations three times by the year 2000 to stimulate oil investments and increase tax revenue. However, despite boosting cash flow for oil companies, none of these relaxations resulted in an increase in government tax revenue from the North Sea. (Abdo, 2010), (Rutledge & Wright, 1998). The current taxation framework for petroleum operations in the UK is based on the 'Ring Fence Corporation Tax' (RFCT) concept. It follows a standard corporate tax approach but includes a 'ring fence' provision aimed at safeguarding taxable profits from oil and gas extraction in the UK and the UK Continental Shelf (UKCS). This provision prevents the erosion of these profits through losses in other business activities or excessive interest payments, a concern for HM Revenue & Customs, UK<sup>1</sup> (HMRC) in terms

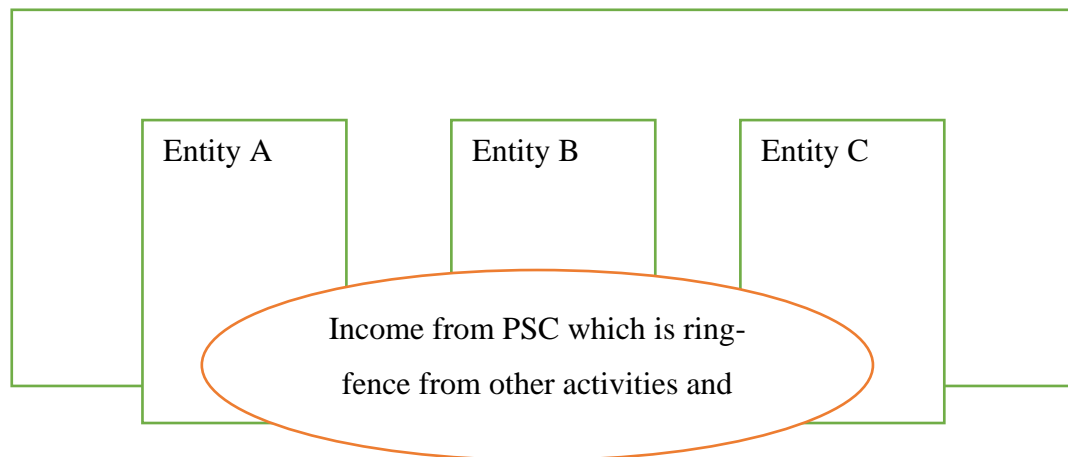
<sup>1</sup> Website of HM Revenue & Customs/Services & Information/Oil and Gas finance and taxation/Ring  
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of taxation. In upstream activities, the conventional framework often involves unincorporated joint ventures, which may rely on funding through mechanisms like cash calls. Alternatively, financing can be facilitated via equity sources, such as shareholder loans and share subscription. Securing third-party financing for upstream projects can be challenging due to the perceived higher risk and less predictability associated with these endeavours compared to downstream oil and gas ventures. The amount of capital needed to develop upstream resources and the precise timing of investment contributions may not always be immediately evident at the project's initiation, making external financing less feasible (Suzanne Szczetnikowicz et al., 2018).

The comprehension of the eligible entity to be subjected to taxation, as delineated in both the PITA and the CITA, stands as a fundamental rule that necessitates consensus among all the parties governed by these legislations. Authority to tax in PITA, is in Section 3, *'Subject to and in accordance with this Act, a tax to be known as petroleum income tax shall be charged for each year of assessment on the income of every chargeable person, being income derived by such chargeable person from petroleum operations'*. While Sec 2(1) defines CP, *'...means, (i) Petroliam Nasional Berhad (Petronas), (ii) Malaysia-Thailand Joint Authority (MTJA), (iii) in relation to each petroleum agreement, any other person carrying on petroleum operations thereunder, severally'*. Item (i) and (ii) which refer to Petronas and MTJA are CP by themselves and there is no dispute on the interpretation where both taxpayers and tax authority have similar understanding. However, on item (iii) where the reference to *any other person...* is where the different application arise. *'Person, includes a company, a partnership or other body of persons and a corporation sole.'* meaning person in the context of PITA can be a company which is a sole entity, or a partnership which includes *joint venture*. The reference to a partnership which consist of partners formed a JV to deal with a petroleum project has raise dispute as to whether each partner will report his tax computation individually or the JV report their tax computation as a JV. In CITA, there is no taxation on partnership, however, each individual partner will be taxed based on the profit sharing each of them received. The difference can be seen in the definition of 'person' define in PITA and CITA. CITA defines 'person' as *'includes a company, a body of persons, a limited liability partnership and a corporation sole'*. Here, limited liability partnership (LLP) is mentioned where an LLP has a separate legal entity under the law while a partnership firm has no separate legal status apart from its partners. CITA emphasize LLP in defining 'person'. A case study byThang, 2004 on Taxation of Contractors in the Oil and Gas Sector (2004), in para 3.1.2 describe CP as, *'..the chargeable person refers to a person who carries on petroleum operations in relation to each PSC. 'Person' includes a company, partnership or other body of persons and a corporation sole. In this context, if the petroleum operations in relation to a PSC are carried out by a partnership, that partnership is regarded as a taxable entity. In this case, the operator is responsible for filing annual petroleum income tax returns on behalf of the partnership (i.e. parties to the JOA), in relation to profits derived from the petroleum operation'*. For an enquiring mind, one would wonder why the two acts, PITA and CITA are keep separate. Arguably the two acts can be combined under CITA where a chapter pertaining to PITA can always be inserted in CITA, similar to other various sectors and activities such as banking, insurance, real estate developer which are addressed in CITA. It also encompasses the taxation of individuals, manufacturing enterprises and trading activities, reflecting the comprehensive nature of the tax legislation. However, obviously that is not the case. The unfamiliarity in PITA

has caused it wrongly interpreted and applied, confused with CITA which is most used and referred. In Malaysia, there will be situation where a group of companies operating within the petroleum industry whereby, they will have a subsidiary as part of the PSC, while other subsidiaries provide services at downstream level. Although, they are within a group of companies, the companies involved in PSC will be taxed under PITA, while the other subsidiaries will be subjected to CITA. In other words, the profit from petroleum upstream activities earned by the PSC will be taxed as entity under PITA and other incomes from the group entities will be declared under CITA, although, for audit statutory purposes both activities, upstream and downstream will be consolidated in one financial statement. The concept of ring-fencing applicable in PITA which seems similar to the RFCT of HMRC. The different definition of 'person to be charged to tax' under PITA and CITA is one of the reason for a separate Act. PITA use *chargeable person* as person to be taxed while CITA used *person* with different definition mentioned in Section 2 of both Acts. The tax rate for PITA and CITA is also different. The chargeable income subject to PITA is tax at 38% while the common rate for corporate tax is at 24% and others such as individuals, SME and applicable to some industry, are tax at differential rates. The differences of tax rate set between CITA and PITA shows the expectation of the government to charge a higher rate on extractive industry and having two acts seem to be understood that the activity from upstream is ring-fenced from downstream and other activities. This is to prevents taxable profits from oil and gas (O&G) being reduced by losses from other activities. Figure 1 shows how the three contractors or entities operating together need to report their profit under PITA.

Questions arise, how are they to combine their income? at what level? If there are expenses not claimable under PSC, where can it be claimed? Can it be claimed at other subsidiary level? this is to be understood and determined clearly. In O&G industry there will be opportunity costs incurred which may not be deductible for tax purposes. They incur the cost with the expectation of more area of O&G will be discovered leading to higher profit.



**Figure 1: Ring-Fencing Income of PSC from Other Activities**

Source: Developed by Author

Figure 1 depicts entities within the JV framework of companies incorporated in Malaysia. However, distinctions arise when considering entities within the JV that function as permanent establishments or entities with ownership originating from outside Malaysia. This aspect

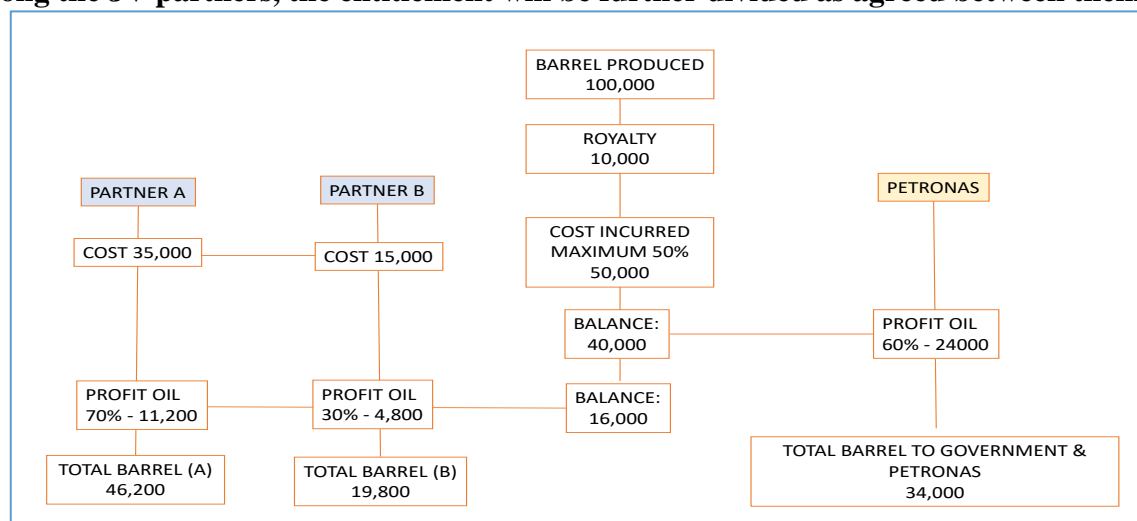
requires more in-depth examination to elucidate the rationale behind such structural arrangements.

## Literature Review

The JV is commonly sighted in a PSC with contribution of capital, division of task and responsibility stipulated in the Joint Operating Agreement (JOA). A PSC is an agreement in which an oil company assumes the full financial responsibility for exploration, development, and operation in exchange for recovering its costs once oil is discovered. The company also shares the resulting profits with the government, typically through the national oil company (NOC), according to a predefined sharing ratio. In this arrangement, the government permits the oil company to bring in its capital, equipment, and technology to explore and exploit oil and gas resources, with the condition that the company recoups its investment and shares profits with the government via the NOC. It's important to highlight that in this contract, the host national company faces little to no risk in the development of the oil field (Ola et al., 2021).

Briefly, the O&G fiscal regime in Malaysia, which can be divided into two eras prior to 1974 and post 1974. Prior to 1974, O&G in Malaysia was under concession regime. After 1974, Petroleum Nasional Berhad (Petronas) under the Petroleum Development Act, 1974 (PDA), the main legislation governing the Malaysian O&G industry, was established. According to the PDA, Petronas was granted complete ownership as well as all exclusive rights, powers, freedoms, and benefits for exploring and exploiting Malaysia's onshore and offshore petroleum resources (Ali, 1985), (Olleik et al., 2021). With PDA, Malaysia adopt the PSC and has more control on the industry. The PSC system was implemented in 1976 to replace the concession-based system. Today's PSC fiscal terms are tailored to the opportunities available, ensuring the most equitable distribution of oil and gas profits between Petronas and investors. Oil companies (contractors) are responsible for the exploration, development, and production of hydrocarbon resources in Malaysia under the terms of the PSC. Contractors assume the risks associated with petroleum activities in contract areas while benefiting from hydrocarbon production.

**The entitlement to CP, will be based on agreed allocation stipulated in the PSC and among the JV partners, the entitlement will be further divided as agreed between them.**



**Figure 2: Example of Entitlement Mechanism - Simple Flow of Allocation Agreed Between NOC And JV Partners in the PSCs.**



Figure 2 refers to the example of allocation in the PSC. Royalty will be allocated to government at the rate of 10% from the barrel produced and the cost oil incurred by JV partners will be allocated back to them in terms of barrel of up to maximum of 50%, in general, however, it will be stipulated in the PSC. The balance will be allocated to Petronas as agreed in the PSC before allocating the remaining between JV partners.

Wigwe-Chizindu, (2019) described the categories of petroleum arrangement in Nigeria and examples from other developing countries in terms of the structure and substance, as well as the financial benefits of such arrangements. He describes JV as a group of individuals or entities coming together, whether through an explicit or implicit contract, to work on a single business project for shared profit, pool their resources, such as money, skills, and knowledge, without forming a partnership or corporation. Their agreement establishes a shared interest in the project's goals, and each member acts both as a principal and an agent, having an equal say in how they achieve their shared objective. He also mentioned, Young and Bradford; Berg, Duncan and Friedman; even in Scots law and United States law is no different, where they define JV as a business arrangement where two or more companies, individuals, or organizations come together. At least one of them may be an existing business seeking to expand its operations to engage in a new, profit-driven, and long-lasting venture. Typically, ownership is divided among the participants fairly, without one party having complete control or dominance. While a partnership, in Anglo Australian terms, is when people work together in a business to make money. Formation of partnership in dealing with outsiders, each partner has authority to act on behalf of the partnership and to bind the other partners. It's difficult to argue that a JV formed solely for prospecting or exploration, is considered as a business or an activity aimed at making a profit. However, the common features of a JV include participants shared interest equally or otherwise as agreed, with a motive, generally profit and will be documented with essentials of a legal contract which may be written or implied. Standard JOA typically include a clause disclaiming any partnership status, primarily for tax and liability reduction purposes among the JOA members. However, the English and Scottish courts exhibit a somewhat ambivalent stance toward such clauses. This ambivalence arises from a conflict between two judicial considerations. On one hand, the courts aim to uphold the legitimate intentions of individuals engaged in commercial activities as defined by their contractual agreements. On the other hand, they also recognize that the mere labelling of a contract does not inherently determine its legal implications. Judicial precedent supports the notion that the courts will delve beyond the surface wording of these labelling or deeming clauses to assess the actual substance of the situation (Styles, 2010). Although there are differences in terms of partnership and JV, PITA do recognised JV as a partnership and as mentioned by Styles, (2010a), the court will analyse beyond the labelling of the group or entities and will assess the actual substance or transaction within the group.

### ***Joint Operating Agreement***

A JV is govern by JOA. The establishment of the partnership aiming at better strength and effort by parties to achieve higher production in an economical and effective way. The term in the contract consists of variety of items which includes, define block area, term of duration, the specific work and budget, right and obligation, contractors' privileges, and clauses on special benefit contractors may offer the government (Althiyabi, 2023b; Pongsiri, 2004). JOA is the mostly common contract among the O&G upstream player. As mentioned by Martin et al., (2020), the basic purposes of a JOA are to ensure a decision-making process take place amongst the joint venture partners, to itemise the conduct and financial contribution of partners in joint operations to perform the obligations, to have written benefits, costs and liabilities amongst the

partners based on their respective interests and to appoint an operator to manage the joint operations on behalf of the JOA parties; and provide mechanisms to allow non-operators to involve in the operations.

There are *sole risk clauses* and *non-consent clauses* in JOA to ease parties having problem or not in agreement in certain situation. In JOA, when the *pass mark* is not reached on the project proposed, parties who are interested with the rejected project can undertake the project on *sole risk basis* without the participation of other parties in the JOA. Commonly, it will be the operator who will undertake the proposed project on sole risk basis (Marshall, 2016). The *non-consent clause* applies to minority parties who voted against an approved project by JOC. In the situation most parties agreed to the conduct the project, the minority who are non-participating will be release from the contribution and risks. The common application of *non-consent clauses* is on high costs project such as development of discovery (Marshall, 2016). *Pass mark* is referred in determining the decision of JOA. *Pass mark* is crucial as it represent the vote of parties with their percentage of interest share in electing the proposed project before JOC make a binding decision (Styles, 2010a), (Marshall, 2016). Although these two clauses are meant to ensure the parties interests are met based on their interest, knowledge and financial capability, Althiyabi, (2023a) describe the situation of undertaking the sole risk and non-consent clause as going against the main objective of the JOA. There are option to reinstate the interest of the non-participant or those who have opt sole risk and non-consent clause to buy back share and the activity, named as 'exclusive activity', will be reconstituted as a joint activity. Accurate and comprehensive record-keeping of activities within a JV is important to mitigate the risk of disputes.

### ***Partners' Obligation***

The JOA also serves the purpose of apportioning participants' stakes in the project, a division that need not be equitably distributed. The allotment hinges on each party's initial contribution to the project, which subsequently delineates its respective share. In addition, the JOA categorizes participants into two distinct roles: operators and non-operators. The operator, typically the entity with the largest share in the JOA and possessing requisite technical expertise, assumes responsibility for the day-to-day administration of petroleum operations. However, the selection of the operator requires nomination by non-operators and approval by the department representing government, with the removal of the operator also necessitating endorsement by the same department (Althiyabi, 2023b). Furthermore, the operator is obliged to conduct the JOA in alignment with the licensing terms and pertinent regulations. It is incumbent upon the operator to perform the JOA with a prescribed level of competence. Notably, the operator should neither accrue profit nor incur losses as a direct consequence of its role, unless expressly stated otherwise within the JOA. Additionally, despite the authority wielded over day-to-day operations, the operator's liability is limited to their proportional share in the JOA. The operator is absolved of liability for honest errors or misjudgements but may be held accountable for wilful misconduct, although not for consequential losses.

Provisions for the removal of the operator are standard in all JOAs, enabling such action in cases of wilful misconduct, material breaches, or the failure to fulfil significant obligations outlined in the JOA. To elucidate the contrasting responsibilities and roles of JOA participants, a detailed examination of non-operators' rights and duties is essential. A primary duty of non-operators is the prompt provision of funds in response to cash calls. Notably, they are considered active investors, affording them the opportunity to participate actively in JOA management through the Joint Operation Committee (JOC) (Althiyabi, 2023b). In certain

JOAs, the comprehensive responsibility for JOA management is delegated to the JOC, comprising representatives from all participating parties. The JOC's mandate involves overseeing and regulating all facets associated with the joint operation. Decision-making within the committee adheres to a specified voting procedure as outlined in the JOA. This voting mechanism typically aligns with each party's proportional interest in the JOA and is subject to adjustment based on the negotiated pass mark, contingent upon the participants' contractual strengths.

In transactions involving independent parties, the differences in their interests typically result in contractual terms that protect the interests of both parties, and they will generally enforce these terms as agreed upon. If the terms do not benefit both parties, they may be disregarded or adjusted. Conversely, when dealing with related individuals or entities, these differences in interests may not be as pronounced, or any disparities that exist can be addressed through the control relationship rather than primarily relying on contractual agreements<sup>2</sup>. In case of a JV, the transactions are between independent parties and each of them will ensure they benefitted from the contract and the decision making they have decided. Issue of non-arm's length dealing may not be in a JV as all parties are independent of each other, this is done with the primary aim of allocating financial responsibilities and risks among the involved parties, thereby preventing any single entity from bearing a disproportionately high burden of losses when independently managing the activities.

### ***Functions of An Operator***

The operator takes on the primary responsibility for day-to-day exploration, development, and production activities, while the remaining interest holders, who are non-operating members, share the costs and production outcomes, if any, of the venture. Only one operator is designated, and their identity is specified in the initial JOA. This JOA also includes provisions for potentially removing the operator and appointing a replacement. The selection of the operator is subject to government approval, with the Minister having the authority to revoke this approval. The operator's role involves representing JOA members in exploiting any reserves obtained under the license. Despite the substantial workload and responsibilities associated with the operator's role, they do not receive direct compensation for their efforts but rather share rewards, if any, proportionally from the venture's production. The question arises as to why any JOA member would want to be an operator, given that it typically involves more authority than increased potential profits. Traditionally, the operator, often the JOA member with the largest stake, is perceived as having a more significant say in the project and being better positioned to take the initiative. During negotiations, the operator usually seeks to limit operator removal provisions to specific causes, such as default or wilful misconduct. They may also aim for a removal clause requiring unanimous agreement among JOA members, granting the operator veto power over removal attempts. In contrast, non-operators may prefer a removal clause without specific cause, based on a majority vote of the members. The outcome of these discussions depends on the relative bargaining power and trust among the parties involved. The JOA also contains clauses addressing the operator's resignation and the process for selecting a replacement (Styles, 2010b).

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<sup>2</sup>CHAPTER II - The Arm's Length Principle | Lembaga Hasil Dalam Negeri Malaysia, 2017 (16 Oct 2023),  
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The operator are mandated to oversee these operations themselves or through their agents and contractors, with the Joint Operating Committee (JOC) providing overall supervision. Even if the operator doesn't directly conduct these operations, they are still accountable as the operator. Key duties of the operator encompass tasks such as preparing programs, budgets, and Authorization for Expenditure (AFE) documents, executing JOC-approved programs, and providing reports and data to co-venturers. As the operator is very much in control of day-to-day operations, one of his major duties to the non-operators is to keep them informed of developments and this will be done by providing the JOC representatives with reports and data.

The operator has a duty of care towards other members.-This duty, defined in the JOA, involves performing the operator's role in a proper and workmanlike manner, adhering to good oilfield practices, complying with relevant legal requirements, and diligently undertaking actions necessary to maintain the project's license in effect. The operator in a JOA is protected from liability within the JOA contract and is only liable to the extent of their ownership interest in the venture. Typically, the operator is not held liable for honest mistakes, misjudgements, or negligent actions or omissions.

### ***Functions of Non-Operator***

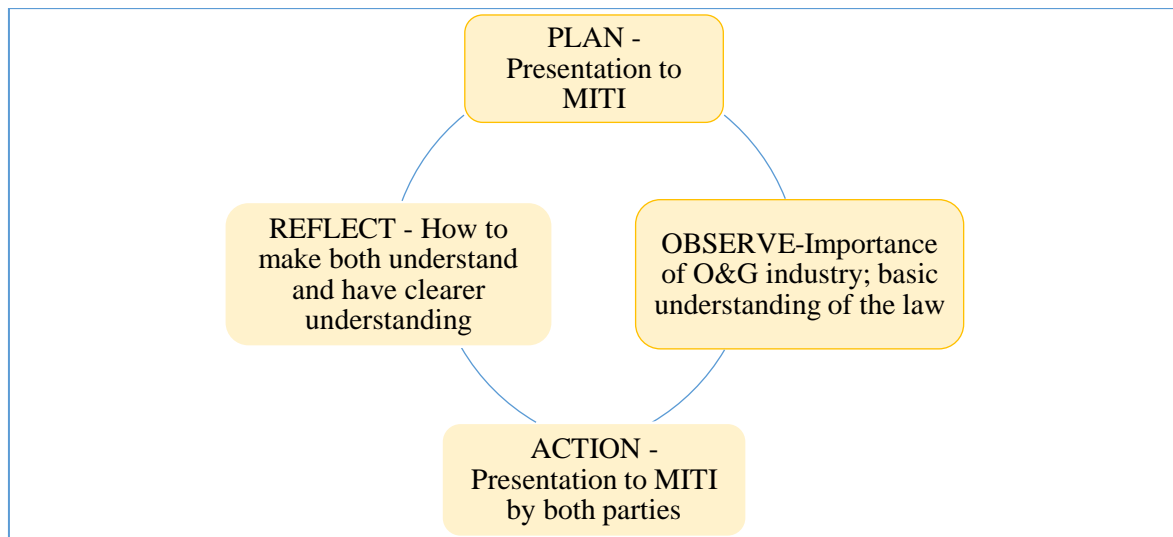
In a joint venture, non-operators primarily assume the role of non-working, non-operating interest owners, effectively functioning as investors. However, these non-operators are not passive investors; they actively participate in project management through the Joint Operating Committee (JOC). A significant responsibility of non-operators is to contribute their allocated funds when confronted with a cash call. Failure to do so results in a default status for any co-venturer who does not meet their financial obligation when called upon to do so (Styles, 2010b).

### **Methodology**

The study adopts the Onion Research Framework using inductive methodologies, leveraging qualitative data to underpin the research findings. According to Merriam, (2002) six conceptual domains, encompassing the aspects of process analysis, meaning, primary research instrument, fieldwork observation, descriptive analysis and inductive methods.

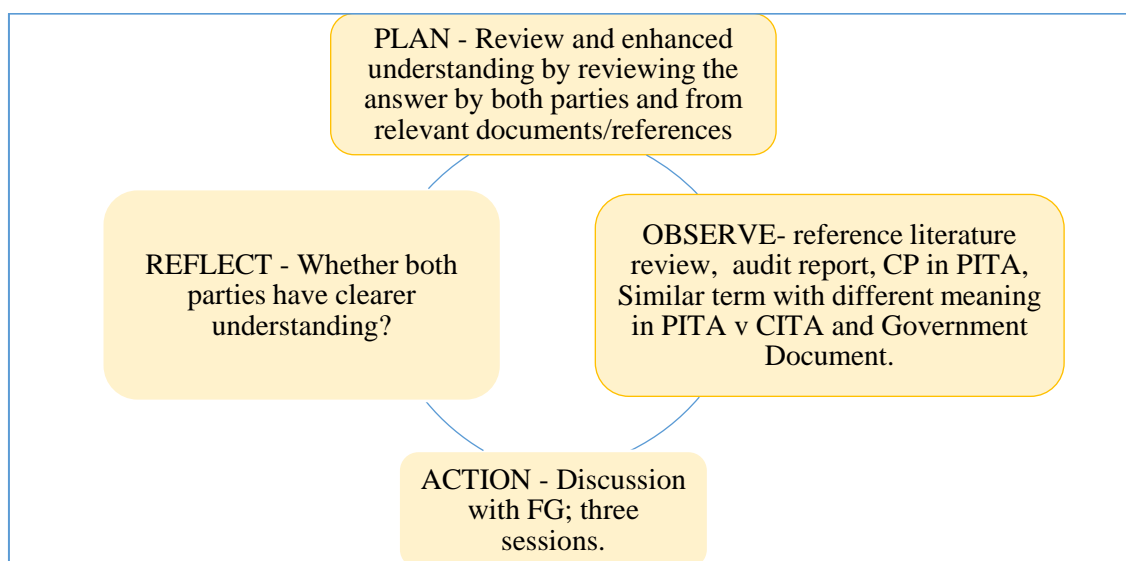
Process analysis dedicated to conducting a comprehensive examination of the interpretation of CP and *meaning* seeks to unearth underlying patterns and in-depth interpretations, delving into terminology in a *descriptive* manner. The *primary research instrument* employed for data collection will be the researcher. Data will be garnered through direct human interaction, employing open-ended questions in interviews instead of relying on surveys. *Fieldwork observation* involves the systematic observation, documentation of observations in their natural context, and transcription of interviews with participants in the focus group (FG). In the *descriptive analysis* sphere, the research will focus on the process, meaning, and comprehension of the statements and behaviour exhibited by participants within the focus group. Using the inductive method, data collection will continue until saturation is achieved, signifying that no further novel responses or answers emerge during interviews. These accumulated data will be analysed to construct a model. This study utilizes an action research (AR) method, which incorporates the organization of three distinct focus group sessions based on the research design outlined earlier. The three groups were formed and consisting of policy maker, industry participants, and policy implementers. Three intervention was formed as below:

During the initial intervention, clarification was provided to the Ministry of International Trade and Industry (MITI), the agency responsible for recruiting investors for the exploration and production of Malaysian petroleum. The meeting convened at MITI with an audience comprising IPs. The purpose was to elucidate the audit findings and the basis for additional taxes raised, ensuring that MITI comprehended the stance of IRBM. Simultaneously, IP presented their representations regarding their activities and challenges, and IRBM offered reasons supporting their position.

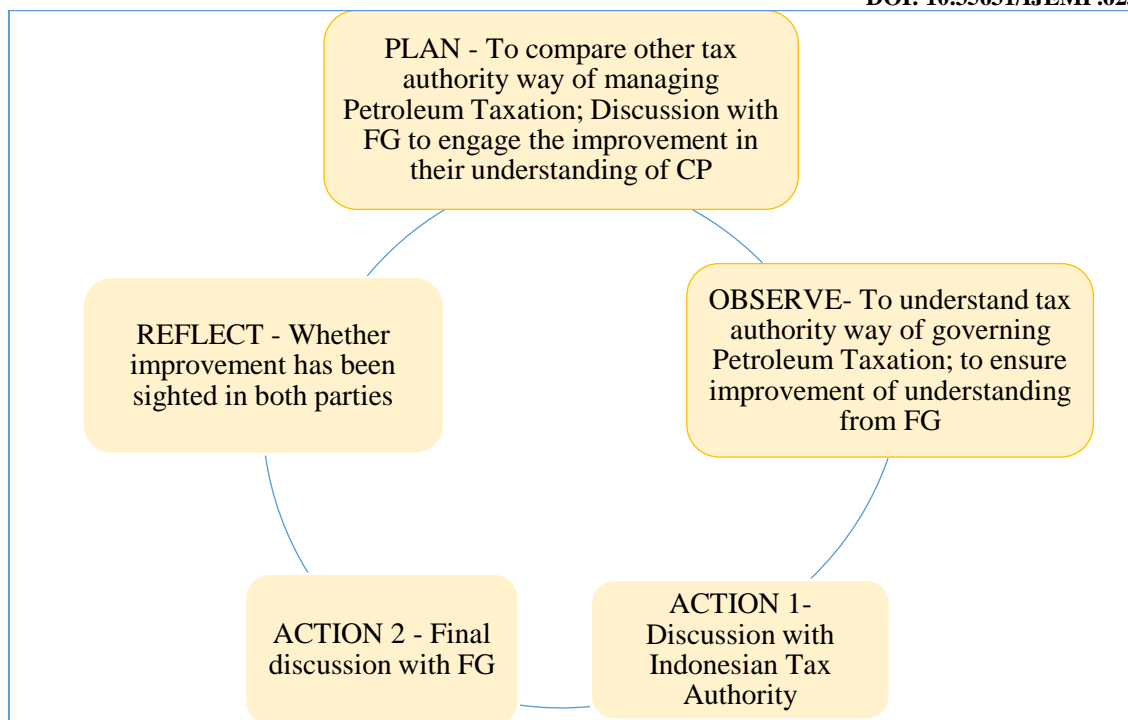


**Figure 3: First Intervention**

In the second intervention, the process of verifying and justifying the solution for problem statement and research questions is based on literature review audit report, CP address in PITA, similar term with different meaning in PITA v CITA and reference to the government document in public domain.



**Figure 4: Second Intervention**



**Figure 5: Third Intervention**

In the third intervention as shown in Figure 5, the practices of other tax authorities, particularly in countries implementing the PSC regime, were employed for comparison with those in Malaysia. Additionally, a further discussion was conducted with FG to ascertain if there had been improvements in their understanding of PITA Section 2.

### **Finding**

The methodology's results centre on the selling price and cost as focal points. The selling price analysis delves into the criteria for determining prices, considering the boundaries of petroleum operations (PO) and the quality of crude. On the other hand, the cost discussion encompasses overall costs, sole costs, Joint Operating Agreements (JOA), and reporting.

### ***Determination of Gross Income & Petroleum Operation***

Within the delineation of petroleum operations, the taxation framework is applicable, commencing at the point of sales, delivery, or export, with the notable exception of the transportation of petroleum beyond the borders of Malaysia, the processes involved in refining, the handling of refined products, and the provision of services and equipment such as rigs and tankers. It is important to note that this taxation framework is equally applicable vice versa when Petronas acquires petroleum from sources outside Malaysia. In the context of taxation, specific considerations arise with regard to the sale of crude oil within a JV arrangement. In situations where, at the culmination of the petroleum operation, the market value of the crude oil can be ascertained, taking into account the quality of the crude oil as a determining factor in its pricing. It becomes imperative to explicitly state whether a single pricing mechanism applies universally to all JV partners or if individual selling prices are to be determined for each partner.

Table 1 summarizes the key elements of Sections 7 through 10. Sections 7 and 8 of the tax provisions pertain to sales to local refineries in Malaysia and for export, in cases where the buyer is an independent third party. In such instances, pricing is expected to adhere to the principles of arm's length transactions and prevailing market rates. Conversely, Sections 9 and 10 underscore the significance of applying market prices when transactions involve related parties or situations where crude oil is refined on behalf of others.

During the period of PO, a provisional price imposed for the determination of cost recovery in determining the barrel allocated to the parties in the JV. Both, Petronas, and Indonesia, mentioned the price in their manual and procedures. PPGUA 3.0, is publicly accessible via internet resources specifically in PPGUA 3.0 volume 9<sup>3</sup>, the document provides comprehensive insights into a myriad of procedural aspects concerning financial reporting, contractual remittances, submission protocols to Petronas, and the cost recovery mechanisms within the operational framework. Notably, this document introduces two pivotal metrics of paramount significance, namely the Gas Entitlement Percentage (GEP) and the Crude Oil Entitlement Percentage (COEP). GEP represents the initial provisional allocation pertaining to the sale of natural gas, while COEP signifies the preliminary allocation linked to the production of crude oil and condensate. COEP assumes a crucial role in facilitating the strategic planning of crude oil lifting schedules for each participating entity, thereby contributing significantly to the operational efficiency of the contractual arrangement.

In the realm of revenue distribution, the Crude & Condensate Allocation Sales Hydrocarbon (CASH) and the Crude Oil Sharing Entitlement (COSE) frameworks represent meticulously structured protocols and standardized operating procedures. These frameworks have been developed to document and equitably apportion the proceeds emanating from oil and condensate sales among the contracting parties. These frameworks serve a dual purpose, primarily by ensuring not only uniformity in the allocation process but also by fostering the equitable dispersal of revenue derived from oil and condensate transactions within the contractual framework.

The price formula in PPGUA may be used to determine the barrels of oil needed to be allocated based on the recovery cost to the partners. However, the price to determine the gross income of the CP will be based on the sections in Table 1. Crude oil is a formed of commodity which by having similar characteristic and quality will have similar price. Therefore, at the end of the petroleum operation, there will be a price that can be imposed on the total barrels of production for the CP, where the risk is still with the partners, before the oil is being transferred to actual buyer. Although in certain occasion the intent to buy has been written, the risk is still with the partners and not yet transferred<sup>4</sup>. The risk is transferred to the buyer at the point of sales or delivery or export depending on the type of freight arrangement between the seller and buyer. However for the determination of selling price for PITA, the end of PO is at POS or delivery or export. The combination of end of PO and the determination of price in Sec 7 through 10

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<sup>3</sup> PETRONAS Procedures and Guidelines for Upstream Activities (PPGUA 3.0) Volume 9, 2013 (dated 12 October 2023)

<sup>4</sup> Malaysian Transfer Pricing Guidelines; Hasil.gov.my/International/ Transfer Pricing Guidelines / Factors Determining Comparability/Risks

will be referred to determine the revenue of the CP of a JV. A set of guidelines will need to be provided to clarify these procedures for the IP and regulators handling taxation of the industry.

**Table 1: Key Elements in PITA Regarding Pricing, Sections 7 – 10**

PITA	Sec 7 Sales of Petroleum - Crude Oil or Gas OR Sales to refinery in Malaysia	Sec 8 Sales of crude oil for Export	Sec 9 Crude oil exported otherwise than on sale	Sec 10 Chargeable petroleum delivered to refinery or gas processing plant; Refined on behalf of CP
Determination of Gross Income - Sec 6	Proceed of sales	Proceed of sales	Market Value	Market Value

The presence of provisional pricing data, including the market price which include the evaluation of crude oil quality streamline the process of allocating and ascertaining taxable income, whether within the framework of JVs or among individual partners. Nevertheless, the model underscores the interdependence of both the selling price and associated costs, emphasizing the necessity of analysing these factors collectively.

The regulation for O&G industry in Indonesia sighted in '*Buku MIGAS*' (*Gambaran Umum Kegiatan Usaha Minyak Dan Gas Bumi*, n.d.-a). The produced petroleum will be valued with referenced to the Indonesian crude price (*Buku MIGAS*, Ch III, rules 22; Page 81). Ministry of Energy and Mineral Resources together with Finance Minister will decide the price of the crude through the methodology of either benchmarking or indexing. The division among contractor and government is based on the price determined by government on the barrel produced and divided based on the equity to be split<sup>5</sup>.

### ***Quality of Crude***

In Malaysia, the predominant varieties of crude oil produced are characterized as medium to light and possess a sweet, high-quality composition as shown in Table 2. This exceptional quality bestows upon them a premium price compared to other crude oils available in the market, as reported by the Energy Information Administration (EIA)<sup>6</sup>. Notably, Tapis oil, sourced from the Tapis field offshore in the Malay Basin, stands out as one of the highest-quality examples in this category. API, which stands for the American Petroleum Institute, serves as the primary global authority for establishing standards within the oil and gas industry. One key metric employed within this industry is API gravity, a measurement that quantifies the specific gravity of crude oil or condensate in degrees. The typical API range for crude oil falls between 15 to 45, with higher API values indicating lighter or less dense crude.

<sup>5</sup> *Gambaran Umum Kegiatan Usaha Minyak Dan Gas Bumi*, n.d.;Ch IV, rules 24; page 83).

<sup>6</sup> Energy Information Administration / Geography / International Analysis / Malaysia; update from January 25, 2021



**Table 2: Selected Crude Blend From Malaysia**

Crude blend	Classification	API gravity	Sulfur content
Kikeh	light, sweet	36.7	0.06
Kimanis	light, sweet	38.6	0.06
Labuan	medium, sweet	29.9	0.03
Miri	medium, sweet	29.8	0.08
Tapis	light, sweet	46.0	0.02

Sources: McKinsey Energy Insights

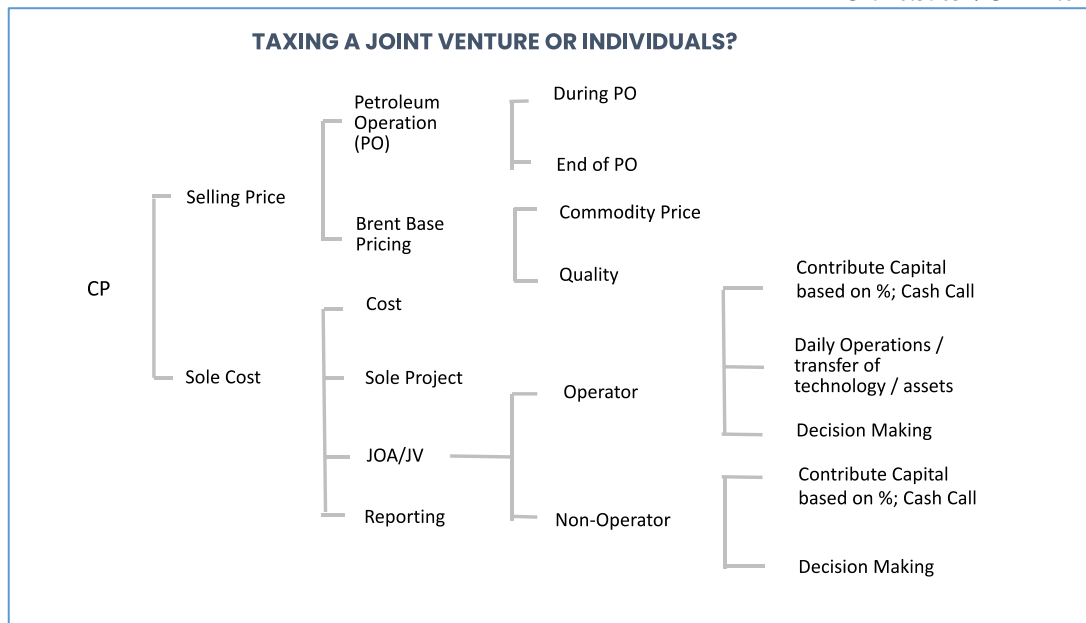
Additionally, it is worth noting that sulphur, a non-metallic element with a yellowish appearance, generates sulphur compounds that have adverse environmental effects. The sulphur content of crude oils exhibits a substantial range, spanning from less than 0.05 to over 10 weight percent (wt%). Crude oils containing less than 1 wt% sulphur are categorized as low sulphur or "sweet," while those exceeding 1 wt% are designated as high sulphur or "sour." In the marketplace, crude oils with lower sulphur content tend to command higher prices due to their favourable environmental characteristics<sup>7</sup>.

### **Cost**

Costs in O&G can be recovery cost, operating cost, joint cost and sole cost. Sole cost was discussed during FG, as a component of cost claimed by CP of a JV. The components of cost is broad may go further into sole project cost, and, as mentioned in the literature review, the clauses in the JOA, may involve the unaccounted cost in the form of non-monetary including usage of assets, transfer of technology, functions of operator, JV and partners themselves. Each term of the cost need to be understood based on the activities and parties involved. Exploration and production cost will be part of recovery cost to a JV, while operating cost as mentioned in Section 15. Joint cost are cost borne by parties collaborating in the project and sole cost will be the cost incurred by an entity for his own project or transaction. However, results of choosing *sole risk clause* (SRC) will lead to a sole risk project which may involve few parties. If it is part of JOA, the reporting of sole risk project may be an account separated from the main project under JOA, depending on the term of JOA. Reporting and documentation are important in a PSC, as to avoid dispute that may arise (Althiyabi, 2023a).

The allowable charges of expenses as stipulated under Section 15 are intricately linked to the utilization of CP structures. These charges of expenses pertain specifically to the costs and expenditures associated with CP operations and activities. Section 15 delineates the scope and eligibility criteria for deducting certain expenses incurred in the context of CP ventures, thus establishing a direct connection between these allowable expenses and the utilization in CP structures. With these understanding, the sole cost claimed by a partner of a JOA will not be allowable, unless the cost relates to the sole risk project incurred by one partner or few partners within the JOA and agreed by most partners in the JV on this sole risk project. Clear description and financial record and accounts of the sole risk project need to be presented.

<sup>7</sup> EIA / Geography / International / Analysis / Malaysia (updated January 25, 2021)



**Figure 6: Rationale of Taxing a JV**

### Conclusion

The outcomes of the applied methodology were a model formed primarily focus on two key transaction elements to ascertain the feasibility and accuracy of taxing JV in comparison to individual partners. These two critical elements pertain to the selling price and associated costs. The selling price was considered within the context of petroleum operations (PO), encompassing both during and end of PO. Additionally, it pertained to the brent-based pricing structure, considering the commodity price and quality considerations. The market value of the crude can be determined at the end of PO.

On the contrary, the cost element was further elucidated to encompass expenses related to the sole risk project in addition to the activities outlined in the Joint Operating Agreement (JOA). This exploration extended to the reporting processes within the JOA framework, with specific attention given to the distinct roles of the operator and non-operator within the Joint Venture (JV). The determination of costs allocated to each partner for their income from crude may lack accuracy, considering the roles and transactions within the JV. Partners in a JV operate independently, and transactions among them are treated at arm's length. Consequently, characterizing taxation based on the inherent nature of these transactions is more straightforward than attempting to alter the characterization of the entire group.

The model formed represent the rationale of the results or conclusions obtained through the methodology and intervention applied.

The result of discussion during FG highlight the two components; sole cost and selling price. Sole cost, as mentioned may results from sole risk project attended by minority within the JOA. There will be two type of sales transaction either sales domestically or cross border. Domestic sales will be to a refinery for conversion into refined product. It can be either direct sales or crude sent to be refined on behalf of the owner. In both cases the selling price will be at market value, unless buyer and seller has contracted and agreed on specified price, the proceed of the sales will be the revenue of the seller. Crude selling to international market will also be at market value. The price to be determined at POS or at point of delivery or export based on

market value for the determination of gross income, where there will be a price to be referred by JV to be charged to tax as a CP. A guidance need to be issued to make clear of the procedures applicable, and specific reference to a market price at end of PO, if the price is the selling price to buyer which may not be the price at POS, then the current PITA need to be reviewed and another study need to be performed.

The common understanding will be the sole cost refer to a cost incurred and claimed by a partner. There are different type of cost including recovery cost, sole cost, joint cost. Sole cost may relate to sole risk project within the JOA which maybe addition to the main activity. Operator will arrange and perform the functions on behalf of other partners. Accounts need to be segregated if activities involved minority of partners. All partners have their role to play in the JV to ensure the success of the JOA; sole cost may not only relate to one partner but may involve a group of minority partners in relation to the sole risk project.

With reference to Figure 6, delineating distinctive roles between partners within a JV is discernible, specifically as operators and non-operators. Despite the allocation of functional responsibilities, the decision-making process necessitates unanimous consensus from all participating partners. The proposition to segregate the JV for individual taxation merits reconsideration. While the apportionment of direct costs and operating expenses lend itself to quantitative evaluation, certain elements resist facile quantification. Notably, remuneration for indirect activities introduces a nuanced layer not readily calculable. Furthermore, the valuation of assets employed and the intricacies of technology transfer or expertise exchange pose challenges in translating into monetary terms. The intricacies inherent in these qualitative facets underscore the limitations of a purely financial delineation within the JV framework.

The fact that partners in a JV are formed with the motive is to ensure the production of oil will be a success, and the entity in the JV are independent of each other where the transactions between them are considered arm's length, to tax as its characterization (JV) is more accurate rather than to break the characterization of the group.

Therefore, in accordance with legal provisions, the utilization of a JV structure as a CP aligns harmoniously with the underlying ethos of partnership frameworks that are pervasive within the O&G industry. The rationale behind this choice stems from the inherent flexibility in partnerships, wherein adjustments can be made within the partnership arrangement to ensure equitable distribution among the participating partners. However, it is crucial to note that for taxation purposes, the declared amount is treated as an aggregate sum, devoid of a detailed breakdown into individual partner allocations. This approach simplifies the tax reporting process, as it precludes the need for an exhaustive analysis of each partner's share within the CP structure.

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