International Agreement or Private Agreement? Uplift Policy in Oil and Gas Taxation in Production Sharing Contracts between Foreign Contractors and the Indonesian Government

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This article examines two questions: (1) whether the Production Sharing Contract in oil and gas sectors between different countries should be considered as an international agreement or a private agreement; and (2) how to formulate uplift in the PSC which contains the value of equity for investors and the State. In the Production Sharing Contract, there is problem of setting the tax on oil and gas sector particularly uplift policy relating to the taxation of income in the state revenue sources. This issue is related to the return of controversy of operational costs recognized by the contractor (cost recovery claim). This tax controversy gave rise to uplift that is only levied on oil and gas State owned Enterprises contracting partners in the scheme of the Joint Operating Body, especially in the old fields with advanced technology (Enhanced Oil Recovery). The controversy is related to the declining production and increased production costs that are recognized by the contractor.

Keywords

Production Sharing Contract, International Agreement, Uplift, Pertamina, Taxes

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I. Introduction

Awareness of paying taxes among the people in Indonesia is still relatively low. Since Indonesia's independence, only 30 percent of taxpayers has paid taxes.[1] Today, 25 million taxpayers were recorded in the Directorate General of Income Tax of the country, although there are approximately 55 million workers and employees with taxable income.[2] Similarly, only 500,000 corporate and entity taxpayers were recorded, even though the Central Statistics Agency ("CSA") revealed in 2012 that the number of enterprises in Indonesia reached to 12.9 million.[3] This discrepancy is due to the consensus among the Indonesians that the payment of taxes did not provide direct benefits to the people, despite of the definition of taxes which states that no direct benefits are necessarily related to the payment of taxes.[4]

Indonesia is a country with significant natural gas reserves and is also a major producer of liquefied natural gas. When Indonesia gained the independence, she had a variety of natural resources, many of which were non-renewable such as petroleum and natural gas (oil) that had been taken by the colonialists.[5] To explore sufficient natural resources, Indonesia not only needs experts, but also requires sufficient capital investment.[6] Exploring and exploiting oil and gas require high costs and risks as well as the expertise and advanced technology that must be owned by Indonesia.[7] In development, revenues from the oil and gas sector in Indonesia has an important role in the state budget revenues. Therefore, this sector needs adequate policy in relation to its management, particularly with regard to state revenue.[8]

With respect to oil and gas management which is done by the foreign contractors, the government earns revenue from the profit shared in the form of non-tax revenue, in addition to the income tax revenue on profit earned by the foreign contractors.[9] The upstream oil and gas industry is very special in terms of business processes,

1 Anandita Budi Suryana, *Mengerek Kepatuhan Wajib Pajak (Hoist The Taxpayer Compliance)* 4 (Kompas newspaper, 2012), *available at* http://www.scribd.com/doc/197689161/Artikel-Kepatuhan-Wajib-Pajak#scribd (last visited on Oct. 25, 2015).

2 *See Harian Bisnis Indonesia,* Apr. 19, 2012, *available at* http://bisniskeuangan.kompas.com/read/2013/02/11/02171978/Sensus.Pajak.Digiatkan.Lagi (last visited on Oct. 25, 2015).

3 Directorate General of Taxation Team, National Guidebook Tax Census 11 (2011).

4 Mardiasmo, Taxation 1 (2011).

5 B. Sanusi, Role of Gas in Indonesian Economy 7 (2002).

6 *Id.*

7 E. Radjagukguk, Indonesian Investment Law 6 (2005).

8 A. Madjedi Hasan, Contracts Oil and Gas Principled Justice and Law Enforcements 5 (2009).

9 *Id.*

management, and taxation. A Cooperation Agreement in the form of the Production Sharing Contract ("PSC") has been signed between the Indonesian Government and the Contractor of Cooperation Contract,[10] in order to provide maximum benefits to the Indonesian people by making the mechanism of production sharing, cost control mechanisms, and managerial mechanism very unique and different from other industries.[11]

The oil and gas industry is risky, expensive, and complicated. Due to the characteristics of high cost and high risk technology, the oil and gas industry should be managed by experts in this field. In accordance with Law No. 44 of 1960 regarding oil and gas mining and Law No. 8 of 1971 regarding Pertamina, oil and gas can be exploited through the contractor in the form of a PSC.[12] From the national interest point of view, the PSCs have some problems including optimized contribution of resource utilization for the national economy, creation of employment opportunities and opportunities for the local private companies to participate in the process, and to ensure the supply of oil and gas for domestic needs. Meanwhile, foreign investors and national private entrepreneurs seek to make profit as much as possible. With regard to the management of oil and gas under the PSC, setting the taxes is another problem. A critical question here is the uplift policy relating to income tax in the State revenue sources.

'Uplift' is the consideration received by the contractor in connection with the provision of bailout funds to finance operations of the PSC that should be an obligation of another participating contractor as described in the Cooperation Contract.[13] In the beginning, Law No. 8 of 1971 regarding Pertamina and Finance Minister's decision No.2 67/1978 explain Pertamina's function as the regulator and the operator (manager) in any mining area.[14] The function of Pertamina as the operator in the PSC in the scheme of the Joint Operating Body ("JOB") results in uplift, i.e., Pertamina's financing obligations are replaced by crude oil plus benefits (uplift). If the replacement is the same as the financing obligations and there are no benefits, it is referred to as 'equalift'; if the replacement is less, it is referred to as 'downlift.'[15] In the case of downlift, Pertamina will look for another contractor or

10 Petromindo, Understanding of A to Z Oil & Gas Tax Indonesia: Concept, Implementation and Implications 1 (2013).

11 *Id.*

12 The Law on State Oil and Gas Mining Company of 1971 [*Undang-undang Pertambangan Nomor 8 Tahun 1971*], § 8.

13 Government regulations About Refundable Operating Costs and Income Tax Treatment in the Field of Upstream Oil and Gas (2010), § 39.

14 *Supra* note 12, arts. 2 & 6.

15 *Id.*

subcontractors to explore and exploit oil fields who will been titled to be Pertamina.[16] All of the exploration and exploitation costs must be borne by the subcontractors which will be calculated at the time of obtaining the oil. Subcontractors normally have a share of 50 percent of the profits, although this percentage depends on the contract.[17] Part of the exploration costs including labor costs, the cost of experts, as well as the rig will be reimbursed by Pertamina (in this case the implementing agency) with crude oil previously bailed by the contractor. This reimbursement is uplift.[18] According to Sutadi P Utomo, observer of the oil and gas tax issues, such oil business system uplift can be explained as an additional acknowledgment (mark-up) of the value investment of potential reserves before the commercial production of ownership reserve development and as fiscal incentive on high risk during the exploration.[19] Asa recognition of the mark-up on the value of the investment outlay, uplift can be thus interpreted as an additional cost.[20] Madjedi Hasan argues that the uplift is taxed if the costs already returned; if there is a cost that has not been restored the uplift should not be taxed.[21]

This problem becomes a controversy relating to the return of operating cost that is recognized by the contractor (cost recovery claim).[22] This tax controversy gives rise to uplift that is only levied on the contracting partners of the oil and gas State owned Enterprises in the scheme of JOB, especially in the old fields with advanced technology (Enhanced Oil Recovery/EOR).[23]

The controversy is related to the declining production and increased production costs that are recognized by the contractor.[24] Uplift tax policy, which began to appear in 2001 through the Director of Income Tax's Letter S-586/PJ.42/2001 and has been in force since 2003, was amended by Letter No. S-156/PJ./2005, scaring investors to hold a Cooperation Contract called the PSC in the scheme of JOB.[25] Investors have fear because of the lack of legal certainty regarding the uplift. In 2005, there was confusion regarding the taxation of uplift and the dispute was brought by taxpayers

16 R. Surahmat, *Oil and Gas: The Excavated The High,* 13 (III) Indon. Tax Rev.Dig.13 (2006).

17 T. Binsarjono, *Divide Results Oil and Gas,*16 (III) Indon. Tax Rev. Dig. 16 (2006).

18 *Id.*

19 S. Utomo, *Understanding Uplift In the Production Sharing,* 20 (IV) Indon. Tax Rev. Dig. (2005).

20 *Id*. at 20.

21 *Supra* note 8, at 203.

22 *Id*. at 14.

23 Bisnis Indonesia, Uplift Oil & Gas Tax Bother Investors (2005).

24 *Supra* note 8, at 14.

25 *See* Tax Oil & Gas JOB Contracts Need to be Reviewed (2005), *available at* http://www.lkbnantara.com/berita (last visited on Oct. 25, 2015).

to the Administrative Court, instead of the Tax Court. This worsened the condition of the oil and gas mining investment, given that there are currently few investors who are willing to hold a work contract with Pertamina/BPMigas (currently the Ministry of Energy and Mineral Resources) through a PSC in the scheme of JOB.[26]

Up to now, Tax Law in Indonesia justdefine income tax as "a tax imposed on businesses in the oil and gas sector, which in general is a business entity in the form of established businesses."[27] In fact, several PSCs are still using the Company Tax Ordinance 1925.[28] At least, there are eleven oil and gas contractors of Pertamina partners so far whose taxes are charged by the Letter of Tax in relation to the presence of objects in the form of the uplift. A few of these oil and gas contractors are Seaunion Energy, HED, Talisman Energy, Husky Energy, and Petro China. Taxation of uplift becomes an issue for some permanent establishments or oil and gas contractors when the settings in the PSC are not clear.

The legal basis of tax imposition becomes more important.The income tax on oil and gas contractors is related to the size of the contractor as well as the amount of oil and gas production sharing between the State and the contractor. The problem is two-fold: one is the taxation arrangements in the field of oil and gas, and the other, the role of uplift in an oil and gas PSC. It leads to the following questions both theoretically and practically:

1. Is the position of an oil and gas PSC an international agreement or private agreement?
2. How does one formulate uplift which contains the value of equity for investors and the State?

This research seeks to find out answer to these questions. To this end, this article is divided into four parts including Introduction and Conclusion. Part two will discuss the position of oil and gas PSC in Indonesia. Part three will explore uplift as one of

[26] *Id.*

[27] F. Hanggawan, *The Indonesian Oil and Gas Law: A Compilation of Reading Materials and* Regulations, 3 Bus. L. Soc'y (2009).

[28] Article 33 (3) of Law No 7 of 1983 concerning Income Tax states that the taxable income in accordance with valid PSC regulation shall be calculated according to the Company Tax Ordinance 1925 and Tax on Interest, Dividend and Royalty (PBDR) 1970. Furthermore, Article 33 (4) of Law No. 10 of 1994 concerning Income Tax states that tax calculation shall be based on the regulations in PSC until the end of contract. This regulation is in conformity with Article 25 (4) of the Law No. 79 of 2010, which provides that the amount of tax payable shall be calculated on the basis of VAT rate prevailing at the time of signing the contract or in accordance with tax rate under applicable regulations in the field of taxation. *See* Mine voice, *Oil and Gas Tax Arrears : Mirror Poor Tax Management Mechanism*, 3 Indon. Corruption Watched Bull. 2011.

the new instruments in imposing tax on the income in oil and gas sector.

II. Position of Oil and Gas Production Sharing Contract in Indonesia

A. The Constitution of the Republic of Indonesia of 1945

Basic philosophy of domination and exploitation of oil and gas in Indonesia is laid down in the Constitution of the Republic of Indonesia of 1945 (hereinafter the Constitution). Article 33 (1) of the Constitution mandates that the earth, water, and natural resources contained therein- including oil and natural gas - are controlled by the State.

In this constitutional provision, the phrase "controlled by the state" is a creative and intellectual ingenuity of the country's founders. If it would be formulated with the phrase "controlled by the Government," then the formulation would have the meaning "can be either controlled by the Central Government or Local Government," since, in accordance with the provisions of State Administrative Law, the Government can mean the Central and Local Government. So, when formulated with the wording, i.e., "controlled by the State," the mandate for the greatest prosperity of the people is limited to the prosperity of the local people referred to areas where oil and gas is found.[29]

Therefore, it is obvious that, in accordance with Article 33(3) of the Constitution, only the State has the right and authority to rule the earth, water, and natural resources contained therein; and these should be used only for the greatest prosperity of the people. Jogi Tjiptadi observed that:

> . . . , the notion of 'used for the welfare of the people' is that: (a) The utilization of oil and gas only has one goal which is the overall prosperity of the people of Indonesia. If the intended purpose is to put more emphasis on local people, it certainly will be formulated with the phrase 'Community Prosperity' and not 'the people's welfare.' This is the subtlety and precision of the Founding Fathers; and (b) Only the state is mandated by the Constitution to hold the welfare of the people because only the state has the authority and obligation to implement the utilization of oil and gas

[29] J. Tjiptadi, Mineral Policy: A New Approach in the Context of the Implementation of State Sovereignty and Exclusive Rights in the Continental Shelf 12 (2003).

nationally.[30]

Article 33 of the Constitution is the ground for the exploitation of natural resources in Indonesia. The phrase, "Right of State to control" denotes that the State to have the full power for natural resource management in Indonesia. Oil and gas production is an important branch for the State.

B. Law No. 22 of 2001

The State control over oil and gas resources is re-affirmed in Article 4 of Law No. 22 of 2001 regarding Oil and Gas (hereinafter Law No. 22).[31] Article 4 provides that the oil and gas industry constitutes a strategic non-renewable natural resource. As contained in the Indonesian mining law, oil and gas are national assets, which are to be controlled by the State. Further, Chapters 2 and 3 of this law regulate the control by the State as the holder of mining rights by establishing the Executive Agency (currently known as SKK Migas).[32]

Mining oil and gas is regulated by Law No. 22. Article 1 of Law No. 22 defines 'petroleum' as "the result of a natural process that forms hydrocarbons into a liquid or solid phase under atmospheric pressure and temperature conditions."[33] These phases include asphalt, mineral wax, and bitumen obtained from the mining process, but does not include coal or other hydrocarbon depositions in the solid form obtained from the business activities of oil and gas. The implementation of business activities of oil and natural gas is in accordance with Article 2 of Law No. 22. It is ground for democratic economy, integration, benefits, fairness, balance, equity, mutual prosperity, welfare of the people, security, safety, legal certainty, and environmental soundness.[34]

Article 2 of Law No. 22 determines that the control of the state's natural resources as referred to in Article 4(1) is held by the government as a holder of mining rights. Besides, Article 2, paragraph 2 states that the government as a holder of mining rights forms the implementing agency. The business activities of oil and natural gas as set out in Article 5 of Law No. 22 consist of: (1) upstream business including exploration and exploitation; and (2) downstream business activities including

30 *Id.*

31 Law of Oil and Gas (2001) [*Undang-undang Nomor 22 Tahun 2001 tentang Minyak dan Gas Bumi*].

32 *Id*. at chs. 2 & 3.

33 *Id.* art. 1.

34 *Id.* art. 2.

processing, transportation, storage, and commercial.[35]

The oil and gas mining law is preceded by the concept of Customary Law Public Nature (customary rights); the opportunity was given by the indigenous leaders, king, or royal dignitary, to the members of the community who for generations have had the expertise for mining (traditional mine). It is not surprising that some places in Indonesia are named after the expertise of its people to forge iron such like "Pulau Tukang Besi" (the island of Blacksmiths, which is better known as Blacksmiths), and Pandeglang (Smith of Bracelet) in Banten.

C. PSC

A PSC is a kind of contract that is not mentioned in the Code of Civil Law (1847) (*Burgerlijk Wetboek voor Indonesie*) or regarded as a contract *inominaat*. An *inominaat* contract, initiated and developed in the community, is a special type of contract compared to other existing contracts.

The PSC is a contract of cooperation in relation to exploration and exploitation of natural resources. It is more favorable to the state, and the results are used for the welfare of the people. APSC agreement or contract is entered into between the Executive Agency and business entities for the purpose of exploration and exploitation activities in the field of oil and gas with the principle of sharing.[36]

Soerdjono Dirjosisworo defines the PSC as: "A partnership with a profit-sharing system between the State enterprises with foreign companies."[37] If the contract is expired, then the machines that were brought in by the foreigners will remain in Indonesia. Cooperation in this form is a foreign loan, which is reimbursedby way of profit sharing to the production of company.[38] If a PSC involves the government as a contractor, it is commonly referred to as a government contract.[39] Yohanes Sogar Simamora translates the PSC into 'government contracts.'[40]

Contractors must accept what has been set by the government in the PSC, *e.g.*, the distribution of oil produced without the possibility of renegotiation. The core of the agreements or contracts in the management of oil and gas is different from other business contracts in general. Position of the parties in determining the consensus

35 *Id.* art. 5.

36 H. Salim, Inominaat Contract Law Developments in Indonesia 38 (2004).

37 S. Dirjosisworo, Company Law concerning Investment in Indonesia 231 (1999).

38 *Id.* at 232.

39 F. Kurniawan, Legal Protection of Intellectual shape of the Oil and Gas as the State Assets through Instrument Contract 75 (2013).

40 *Id.*

is not always affected by economic laws prevailing the market.[41] Political factors are often more dominant in contracts involving the management of oil and gas. This is because oil and gas are part of the natural resources as available in the Indonesian soil, and thus, are also owned by the State.

When the government makes contract with a private entity, the government has to play dual role. On the one hand, the government has a position like any other private subject, while, on the other hand, its position is a public body. In the private scale, the government is treated subject to the rules of the private law. In this situation, all legal consequences arising from the relationship will be applicable. Because the principles and legal provisions in the field of civil law (material and formal) shall also be applicable,[42] basically the government is not immune and can be sued.[43]

In the case of oil and gas exploitation activities, the upstream to downstream activities would occurs when the government is authorized by the Constitution to perform the functions to take care of the natural resources in the form of cooperation agreement. According to Kranenburg and Vegting, the State or government authorities would act as organs of public bodies in the form of private legal personality.[44] The State as a legal subject has assets that belong to its position as an employer as well as a civil legal entity as a contractor or a buyer.[45] This is done because the State in the role of authority is authorized to give power to the business entity or individual in order to conduct business and/or management on digging materials in the Indonesian mining jurisdiction.[46]

When the PSC or Cooperation Contract is a unique type of contract, it is governed by either private law or public law.[47] Everything contained in a government contract has been prepared unilaterally by the government. The oil and gas contractors only have two options: to agree, or not to agree. It is absolutely impossible to renegotiate. Changes in the institutional entity of the government have no effect on the course of a PSC. In addition, the oil and gas contractors are not required to sign the agreement.

41 Frisca Cristi, Liabilities due to Speak Indonesian Law Number 24, 2009 based on Article 31 of the Constitution Act of the Republic of Indonesia against the Production Sharing Contract (PSC) in the Petroleum Sector (2010) (unpublished Master of Law thesis at the University of Indonesia).

42 *Supra* note 39, at 75.

43 *Id.*

44 Y. Sogar Simamora, Principles of Contract Law on Procurement of Goods and Services by the Government 58 (2009).

45 *Id.*

46 *Id.*

47 *Supra* note 39, at 78.

Moreover, the PSC does not require the existence of agreement with the oil and gas contractors.[48]

In the oil and gas contract, the government may be represented by a public body or State-owned Enterprises ("SOEs").[49] Public bodies would perform the functions of the government.[50] The public body representing the Indonesian government in the PSC[51] was initially Pertamina. Later, Pertamina was replaced by BPMigas, which was established through the provisions of Law No.22. The State body was later transferred to the Ministry of Energy and Mineral Resources ("MEMR") by the Constitutional Court Decision No. 36/PUU-X/2012 which canceled a number of articles in Law No. 22 of 2001 concerning Oil and Natural Gas and abolished BPMigas as contrary to the Constitution.

D. International Contract

From the viewpoint of the contracting parties, an oil and gas contract in Indonesia can be a national contract and/or an international contract. According to Sudargo Gautama, an international contract should contain a foreign element, while a national contract is made by two individuals in a jurisdiction of the State that contains no foreign element.[52]

International contracts need to be distinguished between commercial and non-commercial contract with public nature. In the commercial field, international contracts will be subject to the civil law, while, in the non-commercial field, these are subject to public law. Article 1(1) of Law No. 24 of 2000 defines 'international agreement' as "an agreement, in a form and a particular name, which is governed by international law made in writing and causes rights and obligations in the field of public law."[53] To be an international agreement, it must be held by a subject of international law,[54] *e.g.*, the agreement between the States, between States and international organization, or between international organizations.[55]

Although Indonesia's oil and gas contracts involve foreign parties, pursuant to

48 *Id.*

49 *Id.* at 45.

50 *Id.* at 46.

51 Ministry of National Education, Dictionary of Indonesia 896-7 (3d. 2002).

52 S. Gautama, International Trade Law 7 (2004).

53 Law of International Agreement (2000) [*Undang-undang Nomor 24 Tahun 2000 tentang Perjanjian International*].

54 M. Kusumaatmadja, Introduction to International Law 117 (2004). *See also* Black's Law Dictionary 891 (9th ed. 2004).

55 *Id.* at 117.

this definition, they are not categorized as international agreement. Only a State thus can make the oil and gas contract law today, and all forms of mining concession agreements regulate the oil and natural gas income tax on the contractor's income.[56] Types of taxes imposed on the contractor vary depending on the system of tax laws and treaties of contractor operating business as well as the underlying form of agreement of oil and gas business.[57] Basically, the contractor is not required to pay any tax unless clearly defined in the agreement or applicable tax laws. Basic income taxes are different in each form of agreement and depend on the results of production.

Since the commencement of oil and gas business in the country, Indonesia has known three types of oil and gas contracts. These are: (1) 5A contract applicable in the Dutch East Indies government until the end of 1963; (2) Contract of Works ("COW") which prevailed from 1963 to 1993; and (3) PSC which replaced COW.[58]

The Income Tax Law states explicitly about the special treatment of a PSC in Article 33A (4) which states that:

> Taxpayers who conduct business in the field of oil and gas, mining and other mining based on production sharing contracts, contract work, or the mining business cooperation agreement valid at the time of enactment of this Act, the tax is calculated based on the provisions of the production sharing contracts, contract work, or the mining business cooperation agreement until the termination of the contract or agreement.[59]

The provision of this article is reinforced in the same explanation, namely:

> The provisions in the tax sharing contract, contract work, or mining business cooperation agreement is still valid at the time of enactment of this Act, shall remain valid until the end of the production sharing contracts, contract work, or the mining business cooperation agreement.[60]

Although this law has come into force, the taxpayers who are bound by the PSC, contract work, or mining business cooperation agreement are still liable to pay the tax under the contract or agreement concerned. Thus, even though the Income Tax

56 R. Simamora, Oil and Gas Law 49 (2000).

57 *Id.*

58 *Id.* at 50.

59 Income Tax Law (2004).

60 *Id.*

Act was reformed in 1983 and amended numerous times with its latest amendment in 2008, the tax provisions contained in the PSC shall remain valid until the expiration of the contract. The tax provisions mentioned include the tariff and the method of calculating the tax payable by the contractor.

To the PSC signed prior to 1984, the Decree of the Minister of Finance No.267/KMK.012/78 dated July 19, 1978 shall be applicable, and the letter of the Minister of Finance to the Ministry of Energy and Mineral Resources No. S-433-A/KMK.012/1982 dated May 6, 1982, shall be used as an aid concerning the interpretation of the Decree of the Minister of Finance No.267/KMK.012/78.[61] Under its terms, tax is imposed on the foreign oil companies specifically (*lex specialist*); general provisions are applicable when there are no specific rules set out in the contract.[62] Meanwhile, production sharing contractors who signed the contract on or after January 1, 1984, are subject to the Law No. 7 of 1983 regarding income tax. In line with this, the Finance Minister has issued new regulations for the PSCs. These regulations are contained in the Decree of the Minister of Finance No. 458/KMK.0121/1984 regarding the procedures for calculation and payment of income tax payable by the contractor who hold a PSC in the exploration and exploitation of oil and gas with Pertamina. This is subsequently amended by the Decree of the Minister of Finance No. 815/KMK.012/1985 and Regulation of the Minister of Finance No. 257/PMK.011/2011 concerning the procedures for withholding and payment of tax on income from other contractor income in the form of uplift or other similar remuneration and/or income from the transfer of participating interest.

III. Uplift as a New Instrument Imposed on Taxable Income in Oil and Gas Sector

The term 'uplift' has some equivalent terms, such as lifting, compensation for bailout capital, additional value to be paid, and financing scheme in the form of crude oil. These terms can be used as a reference in understanding the concept of uplift. From these four terms there is one essential element that must be understood first. This

61 *See generally* Indonesia Finance Department, *available at* http://www.sjdih.depkeu.go.id/Ind/Search/DetilPMKAll.asp?Read=1&min=2770&max=2950&strKdBentuk=KEP; http://www.ortax.org/ortax/?mod=aturan&hlm=419&page=show&id=8916 (all last visited on Oct. 25, 2015).

62 Budy Pranowo Adi Nugroho, *Taxation of Uplift on Production Sharing Contract in Oil and Gas Sector* (2004) (unpublished Master Thesis at the University of Indonesia) (on file with the author).

essential element is the word 'up.' Meanwhile, the support element in question is 'lift' or 'lifting.'

There are various definitions of the word 'uplift' which translates in Indonesian to 'lift' or 'raise.' Rachmanto Surahmat and Gunawan Pribadi defined 'uplift' as "a form of financing scheme to pay the liabilities in the form of crude oil."[63] Meanwhile, Gunawan Pribadi explains 'uplift' by citing provisions in the Enhanced Oil Recovery Contract as follows:

> Pertamina shall reimburse contractor an amount equal to all funds provided by contractor for Pertamina's Participating Interest share in Pilot Program and development of Enhanced Oil Recovery Operation subject and limited to the following method: capital costs, as defined in the Accounting Procedure plus a 30% uplift thereon-out of sixty five percent (65%) of Pertamina's entitlement of contractors Participating Interest share of Incremental Oil. Non- Capital costs, as defined in the Accounting Procedure plus a 30% uplift on such Non-Capital costs but without Operation Expenses-out of one hundred percent (100%) of Pertamina's Participating Interest share of incremental oil provided that Pertamina's Participating Interest share of Expenses shall be reimbursed preferentially over the other Non-Capital Costs.[64]

If a contractor provides for a year a total bailout of USD 9 million that is used, *e.g.*, for Capital Costs (USD 2 million), Non-Capital Costs (USD 3 million), and Operating Expenses (USD 4 million), the contractor will then get back the issued bailout funds plus an uplift of USD 1.5 million. Thus, by investing USD 9 million, the contractor will receive a return of USD 10.5 million. By Rachmanto's definition, the return value of USD 10.5 million refers to the uplift even though the quote above is quite clear that the uplift is the additional value that must be paid by Pertamina in addition to the principal bailouts, i.e., USD 1.5 million. In this case, 'uplift' is defined as the compensation in connection with the use of bailout funds provided by the contractor to be paid by Pertamina in the form of crude oil.[65]

The phrase, 'lifting costs' means the cost of producing oil and gas after drilling is complete, but before the oil and gas is removed from the property. They include transportation costs, labor, costs of supervision, supplies, the cost of operating the pumps, electricity, repairs, depreciation, on certain royalties payable to the lessor, gross production taxes and other incidental expenses.[66]

63 R. Surahmat. *Divide the results of Oil and Gas*, 17 Indon. Tax Rev. Dig. 17 (2006).

64 Mining Companies and the State Oil (Pertamina), Production Sharing Contract Model.

65 *Supra* note 63, at 17.

66 Black's Law Dictionary 1011 (9th ed. 2004).

The definition of uplift before the entry into force of Regulation No. 79 of 2010 regarding Operating Costs is Refundable and Income Tax Treatment on Oil and Gas Business Sector that uplift has characteristics as loan repayments and its interest. In this definition, uplift as an object of income tax is limited to the excess of the value of sales uplift above the amount.[67] Meanwhile, after the entry into force of Regulation 79/2010, uplift is treated as the consideration received by the contractor in connection to the provision of bailout funds to finance an Operations Sharing Contract. If so, there is a shift in the definition of uplift before and after the entry into force of the Regulation 79/2010. Before the entry into force of the Regulation 79/2010, uplift occurred between the contractor and Pertamina in the form of crude oil. After the introduction of Regulation 79/2010, however, uplift can occur between the contractor and Pertamina or between contractors and may involve benefits that are not necessarily in the form of crude oil.

Of course, a question may arise on the use of the term 'uplift,'[68] mainly because the Constitution has not yet referred to the uplift. If the uplift is a part of the management of oil and gas in accordance with the Constitution, then the term 'uplift' can be searched in a juridical context based on the Constitution. In that context, however, the term 'uplift' would not be found. Government Regulation No. 79/2010 would evidently proves the process of social changes. This is evident from not directly use of uplift textually.[69]

Uplift occurred in Indonesia due to the development of the petroleum industry and natural gas. Article 33 (2) of the Constitution refers to the "[P]roduction branches which are important for the country and that dominate the life of the people controlled by the state."[70] Therefore, the upstream sector of the oil and gas industry is executed basically by PSC forms, namely contractors who have an interest in a particular region to bid to the Government through Pertamina.[71]

Pertamina's superior authority (currently the Ministry of Energy and Mineral Resources) was given the same opportunity to explore that other foreign contractors would have. Pertamina has a working area that is overseen by itself for exploration preparation. It then invitescontractors working on his/her area with a certain participating interest. In this case, Pertamina will stand parallel to the contractor.

67 Government Regulation 79 (2010).

68 *Supra* note 8, at 14. *See also* S. Riphat, Uplift Taxation Perspective of the Income Tax Act 10 (2005).

69 Riphat, *id*. at 4.

70 Constitution of the Republic of Indonesia (1945) [UUD NRI 1945].

71 Initially, the authority was granted to Pertamina by Law No. 8 of 1971 regarding Pertamina, which was, later, replaced by BPMigas based on Law No. 22 of 2001 and finally transferred to the Ministry of Energy and Mineral Resources ("MEMR") based on Presidential Decree No. 95 of 2012.

This means that Pertamina also acts as a contractor. In this scheme, Pertamina should be responsible for managing the working area in accordance with the participating interest. If Pertamina cannot contribute to the financing in question, then s/he will provide bailout. If the production has already been started in the work area, the contractor will perform the uplift that is necessary to get back bailouts that have been issued and its addition. According to the Letter of the Ministry of Finance of the Republic of Indonesia,[72] 'uplift' is paid in the form of crude oil by Pertamina to foreign oil contractors with a PSC as compensation for the bailout funds; it has been granted by the headquarters of the foreign oil contractors to finance the operations of the PSC that should be part of Pertamina's participation in the financing obligations. Uplift is thus considered as equivalent to the interest of income tax. Article 1 (3) of the Regulation of the Minister of Finance No. 257 states that the uplift is the provision of bailout funds to finance the operation of the PSC that should be an obligation of another participating contractor.[73]

Meanwhile, Pertamina states that uplift is the excess (50%) that is paid by Pertamina to foreign contractors as agreed in the PSC/JOB.[74] The compensation for the bailouts has been provided by the foreign contractors to finance the operations of the PSC. It should be an obligation of participation of Pertamina in the financing.[75] Whether uplift should be the object of taxation is not yet a point at issue. Tax policies on uplift emerged in 2003, but it is feared they could scare investors away from making a JOB.[76]

Sutadi P Utomo explains that, in the oil business systems, uplift is an additional acknowledgment (mark-up) of the value investment of potential reserves before commercial production of ownership reserve development as well as fiscal incentive on high risk during the exploration.[77] Because of the recognition of the mark-up on the value of the investment expenses, 'uplift' can be interpreted as an additional cost. Meanwhile, Rachmanto Surahmatopines that the interest contained in it is neither an income, nor the object of the tax; if uplift is subject to income tax, it is not

72 The official name is "Letter of the Ministry of Finance of the Republic of Indonesia, Directorate General of Income Tax to the Head of Regional Office VI especially number 586/PJ.42/2001 regarding Income Tax Treatment on Uplift and Shipping Company/Flight Abroad Company."

73 Peraturan Menteri Keuangan Republik Indonesia Nomor 258/PMK.011/2011 [The Rule of Minister of Finance No. 258/PMK.011/2011] (Dec. 28, 2011), *available at* http://www.sjdih.depkeu.go.id/fullText/2011/258~PMK.011~2011Per.HTM (last visited on Oct. 25, 2015).

74 Pertamina CEO, Letter No.341 / COOOOO / 2003 addressed to the Minister of Finance on Income Tax Treatment on uplift (2003).

75 *Id.*

76 *Supra* note *25.*

77 *Supra* note 19.

in line with the formulation of Article 4 of Income Tax Law.[78]

Rachmanto Surahmat says that taxation, especially income tax, generally cannot be fully appliedon uplift.[79] According to Rachmanto, in the exploration stage, there are costs to be incurred and completely borne by the contractor. If the contractor cannot get the oil or the oil is not economically sound for development, then the fee will be lost. Exploration is followed by exploitation. The tax is imposed upon the profit that the oil and gas contractors make from the oil selling (exploitation phase). As described in Article 31 (4) of the Oil and Gas Law, the obligation to pay taxes shall be in accordance with tax laws applicable when the PSC is signed.

To further ensure a more independent oil business by Government Regulation No.27/1968, Indonesia established the State company. Government Regulation was repealed and replaced by Law No. 8/1971 regarding Pertamina, which gives rights to Pertamina to seek oil and gas in Indonesia, including exploration, exploitation, refining, processing, transportation, and sale of those resources.[80] The company is given the State flexibility to hold a PSC. This is a way to fully implement the ownershipof oil by the State.

Some experts say that uplift as an additional charge, while the other does not regard it as income tax because it is not in line with the provisions of Article 4 of the Income Tax Law.[81] As these various definitions of uplift have clearly resulted in legal uncertainty in the oil and gas taxation, the investors are very cautious to make a PSC. It is not proper to say that the definition of uplift has shifted because the initial uplift definition does not appear in legislation. As Kelsen and Nawiasky described in their books General Theory of Law and State, and *Allgemeine Rechtslehre als System lichen Grundbegriffe*[82] - the lower rule should not be contradicted with the higher rules. The definition of 'uplift' currently contained in Article 1 (15) of Government Regulation No. 79/2010 is inchain of the legislation hierarchy of Indonesia. If the definition is based on the affirmation letter, however, it can not be said valid because the affirmation letter is not included in the hierarchy of legislation in accordance with Article 7 of Act No. 12 of 2011 regarding the Legislation Hierarchy of Indonesia.[83] Kelsen revealed that a legal norm is always based on and derived from

78 *Supra* note 16.

79 *Supra* note 64.

80 *Id.*

81 *Supra* note 12. *See also supra* note 16.

82 H. Kelsen, General Theory of Law and State 113 (1945). *See also* H. Nawiasky, Allgemeine Rechtslehre als System lichen Grundbegriffe 31 (2nd ed. 1948).

83 Act No. 12 of 2011, art. 7. The legislation should be based on the sort order legislation consisting of: 1. The Constitution of the Republic of Indonesia; 2. People's Consultative Assembly Decree; 3. Law / decree; 4. Government

higher norms, but these legal norms are also a source of lower legal norms thereof.[84] Before the entry into force of Regulation No. 79/2010, uplift occurred between the contractor and Pertamina as remuneration in the form of crude oil. Since the entry into force of Regulation No.79/2010, uplift has occurred between the contractor and Pertamina or between two contractors. In this case, it can be remunerated not only in the form of crude oil, but also another form of payment.

The term, 'uplift' should be described in Income Tax Law, and the Law of Oil and Gas, along the terms of royalties, interest, or dividends. If, in making the PSC/JOB, uplift would cause double taxation, it would be better to abolish the uplift policy due to seriously unfavorable influence on the business climate. However, if the uplift benefits the state as a part of State revenue, the uplift should be made clear so that there remain no room for debate on it. W. Friedmann addressed it as follows:

1. Rights of state to control in Article 33 of the Constitution of the State Republic of Indonesia Year 1945 position the state as a regulator and guarantor of people's welfare. The functions of the state cannot be separated from one another, meaning that in order to release a business field of natural resources to cooperatives, private law should be accompanied by other forms of regulation and supervision of a special nature. Therefore, the obligation to realize the overall prosperity of the people is still controlled by the state.

2. Rights of state to control in Article 33 of the Constitution of the State Republic of Indonesia Year 1945 confirms that the state should seek natural resources relating to public utilities and public services, on the basis of philosophical considerations, public interest, political considerations, economic considerations, for the sake of the general prosperity, and for the greatest prosperity of the people.[85]

In general, the income tax is not applied completely because in the exploratory stage there are costs to be incurred and borne by the contractor. If the contractor cannot find resources that are economically sound for development, these costs will be finally lost. These are 'sunk costs.'

In these circumstances, uplift cannot be subject to income tax. Article 4 of Income Tax Law provides that taxation shall be imposed on the income provided by each additional economic capability received or accrued by the taxpayer, in and out of

Regulation; 5. Presidential Regulation; 6. Provincial Regulation; and 7. Regulation of the District / Town.

84 H. Kelsen, Einleitung in die Rechtswissenschaftliche Problematik (Pure Theory of Law) 116 (1934).

85 Tri Hayati, *Concept Mastery State Concept at Natural Resources Sector Pursuant to Article 33 UUD 19,* 17 Jakarta: MKRI Secretary General and CLGS FHUl (2005).

Indonesia.[86] So, in this case, if the contractor fails to find resources to develop, the uplift cannot be subject to income tax because it is not an income. At this stage, the sunk costs are directly charged to run out and not amortized. The oil and gas production will be reduced entirely until fully recovered. The taxation will be done only after the cost recovery funds have run out. Thus, the taxes are imposed upon contractors only when they earn income or when oil is sold. It means that income tax, in general, cannot be fully applied.[87]

Currently, tax on income generate the only State revenue in the oil and gas sector of Indonesia. There are some other potential taxes than income tax, such astax payment with Natura, Windfall Profit Tax, and Farm-in-Farm out Tax. *E.g.*, the US and Venezuela have applied the Windfall Profit Tax to the entities doing business in the oil and gas sector. In principle, tax shall be paid by crude oil.[88] They did not pay taxes in the form of money, but crude oil or by submitting the results of the earth.

IV. Conclusion

The PSC is a unique type of contract that is charged on the one side by private law and on the other side by public law (international law). Although Indonesia's oil and gas contracts involve foreign parties, they are not categorized as international treaty because it is governed by the national law of the country concerned and may constitute a concession or other form of agreement.[89] Foreign oil companies are taxed specifically (*lex specialist*). General provisions are applicable when there are no specific rules set out in the contract.[90]

Meanwhile, uplift is formulated in the PSC which contains the value of equity for investors and the State. Previously, no tax laws explained exactly what 'uplift' means. Because the rules are not clear, 'uplift' has several definitions. The Letter of Directorate General of Income Tax defines uplift as a payment in the form of crude oil by Pertamina to foreign oil contractors with a PSC in connection to the use of bailout funds. The Letter continues to maintain that it has been granted by the headquarters of the foreign oil contractors to finance the operations of KBH

86 Income Tax Law (2008) [*Undang-undang Nomor 36 tahun 2008 tentang Pajak Penghasilan*].

87 *Id.* art. 4 (1).

88 M. Siahaan, Tax Debt, Liability and Billing Compliance with Letter of Forced Disappearance 179 (2004).

89 *Supra* note 54.

90 *Id.*

which should be part of Pertamina's participation in the financing obligation. The definition was then shifted following the Government Regulation No. 79/2010 in conjunction with the Finance Ministry Regulation No. 257/2011. Here, 'uplift' is described as the benefits received by the contractor in connection with the provision of the bailout fund for financing the KBH operation. It should be an obligation of another participating contractor.

Such various definitions without clear rules and regulations have clearly resulted in a lack of legal certainty in the taxation of oil and gas sector. It will have a certain impact on investors who want to make a PSC. The definition of uplift can be said to shift because the initial uplift definition does not appear in legislation. If referring to the theory of hierarchy of law described by Kelsen and Nawiasky, the lower rule should be in consistent with the higher rules. Accordingly, the current uplift definition laid down in Article 1, paragraph 15 of Government Regulation No. 79/2010 will be its basis because the Letter of the Directorate General addresses the hierarchy of legislation in accordance with Law No.12 of 2011 on the Legislation Hierarchy of Indonesia.

Kelsen revealed that a legal norm is always grounded in its higher norms, but these legal norms also become the source of another lower legal norms thereof. The term, 'uplift' should be contained in Income Tax Law, or Oil and Gas Law, as well as the terms of royalties, interest, or dividends. If, in the making of the PSC/JOB, uplift should cause double taxation, it would be better to abolish the uplift policy, because of the serious influence on the business climate. However, if 'uplift' benefits the State with national income, the uplift should be clarified so as to prevent a debate leading to legal uncertainty. The tax is imposed for prosperity. Therefore, the formulation of uplift that contains the value of justice for investors and the State should be enshrined in legislation including Affirmation Letter or Government Regulation. If uplift policy lacks the value of justice for investors and the State, however, it should be abolished, so that its implementation will be fair to investors and the State.