Briefing Note on the Equalization Measure, Subsidies, State Owned-Enterprises, State Contractors and the Enterprise

Introduction

The need for an equalization measure was agreed at the March (2024) Council session of the International Seabed Authority (ISA).

The equalization measure would ensure that Contractors face similar rates of payment (effective tax rate) to land-based miners regardless of any sponsoring state tax exemptions that they do, or do not, receive. Under the equalization measure, Contractors that paid little or no sponsoring state tax would pay more to the ISA: while those Contractors that paid significant sponsoring state tax would pay less to the ISA.

Two equalization measures have been proposed[1], namely:

- Option 1: Hybrid (of an Additional Royalty and a Top-up Profit Share); and
- Option 2: Additional Profit Share.

At the July (2024) ISA council thematic session on the equalization measure, the Enterprise and Member states raised numerous questions, which may be paraphrased as:

1. Is the Hybrid's reference to subsidies and tax exemptions redundant given that the 1994 Implementation Agreement[2] bars certain subsidies?
2. Are state owned-enterprise (SOE) Contractors liable for the equalization measure?
3. Are state Contractors liable for the equalization measure?
4. Is, and if so should, the Enterprise be liable for the equalization measure?
5. Is, and if so should, an Enterprise joint-venture, be liable for the equalization measure?

This Briefing Note explores these questions. It aims to stimulate discussion and to provide useful information to the Equalization Measure Working Group. This Briefing Note does not constitute formal legal advice or provide the last word on any of these questions.

Is the Hybrid's reference to tax exemptions and subsidies redundant given that the 1994 Implementation Agreement bars certain subsidies?

The Annex to the 1994 Implementation Agreement[3] provides in sections 6.1.b and 6.1.c that there shall be no subsidization of activities in the Area except as **may be permitted** under the General Agreement on Tariffs and Trade (GATT) and its successor or superseding agreements.

The Agreement on Subsidies and Countervailing Measures (Subsidies Agreement) of the World Trade Organization (WTO) is a successor agreement to GATT. It defines subsidies broadly as: a financial contribution by government that provides a benefit and which is specific (that is only given to one company or a special group of companies).

However, despite defining subsidies broadly, the Subsidies Agreement only prohibits subsidies that are contingent in law or in fact on export performance, or on the use of domestic over imported goods.

[1] These equalization measure options were included in the Equalization Measure Working Group's proposal.
[2] Available at: Agreement on Part XI UNCLOS
[3] Available at: 24-scm.wpf (wto.org)

The Subsidies Agreement also provides for subsidies that are not prohibited but which are actionable. A subsidy is actionable if it injures the domestic industry of another country or if it causes serious prejudice to the interest of another country.

Under the Subsidies Agreement, if a member government considers that a prohibited or actionable subsidy is being granted then it can refer the matter to the WTO's dispute settlement procedure and then, if no mutually agreeable solution is reached, to the WTO Dispute Settlement Body. However, for actionable subsidies, the complaining country must demonstrate adverse effects.

The Hybrid referring to tax exemptions and subsidies does not contradict the bar on subsidies provided by the 1994 Implementation Agreement, and is also necessary, as:

1. The Hybrid is penalising (through the payment of an additional royalty) a Contractor that has been granted a tax exemption or subsidy: it is not providing for, or allowing, a subsidy or tax exemption. Thus, it does not contradict the 1994 Implementation Agreement's bar on certain subsidies;

2. the phrase 'may be permitted' in section 6.1.c of the Annex to the Implementation Agreement could be interpreted to bar prohibited subsidies but not actionable subsidies. An exemption from corporate income tax would then not be barred by the 1994 Implementation Agreement but would still result in a Contractor's effective tax rate falling below that faced by land-based miners.

3. even if the phrase 'may be permitted' is interpreted (and this may be the better interpretation) as barring both prohibited and actional subsidies, there is still a need for the Hybrid equalization measure to refer to 'tax exemptions and subsidies' as:

    a.) it may be hard for any state party to demonstrate that a corporate tax exemption provided by a sponsoring state to a Contractor caused injury to its domestic industry or serious prejudice to its interests; and

    b.) in practice, published sponsorship agreements demonstrate Contractors have been granted tax exemptions, and neither the ISA Secretariat nor any of the 170 Members of the ISA have argued that this contravenes the 1994 Implementation Agreement and/or Subsidies Agreement. In addition, in practice, no Member state has started WTO proceedings due to tax exemptions or subsidies provided to a Contractor.

Are state-owned enterprise Contractors liable for the equalization measure?

Draft Exploitation Regulation 64 Bis provides that 'The Contractor […] shall pay the equalization measure […].'[4] The term 'Contractor' is defined in the Schedule to the Draft Regulations[5] as '[…] a party to an Exploitation Contract […]'. The United Nations Convention on the Law of the Sea (UNCLOS) provides in Article 153 that state-owned enterprises ('SOE') can be party to exploitation contracts.

Thus, a SOE that is party to an exploitation contract is a Contractor and is liable for the equalization measure.

[4] IBID (1).

[5] Draft regulations on exploitation of mineral resources in the Area, Consolidated text, ISBA/29/C/CRP.1, 16 February 2024, available at: Consolidated_text.pdf (isa.org.jm).

In most jurisdictions, SOE have their own legal personality and are liable for corporate income tax and other taxes. These taxes would be creditable against the Additional Royalty, Top-up Profit Share, and Additional Profit Share. If a SOE had been provided with an exemption from corporate income tax, then it would have less to credit against the equalization measure and would pay more to the ISA, which is concordant with the purpose of the equalization measure.

One potential issue is whether dividend payments from SOE to their sponsoring state should be creditable. These payments should, arguably, not be creditable as:

1. crediting dividend payments could lead to lower rates of payment for SOE deep-seabed miners than land-based miners, which is contrary to the provision of the 1994 Implementation Agreement;
2. dividend payments are not part of the taxes paid by companies, but are rather compensation for the risk taken by owners in providing equity; and
3. dividend payments by private sector contractors would clearly not be creditable as these are paid to their owners and not the sponsoring state. Allowing SOE to credit dividend payments would thus create an uneven playing field.

Given the above points and judging by the Equalization Measure Working Group's previous discussions, the likely intention was to not allow SOE deep-seabed miners' dividend payments to be creditable. However, the very broad definition of Covered Payments (see below) that are creditable against the Additional Profit Share could be interpreted as providing for the crediting of SOE's dividend payments; albeit the requirement for a signed letter from the tax authority may provide some protection.

> 1. A Covered Payment is:
>
> (a) the actual cash payment by a Contractor to a sponsoring State for payments relating to income, profits or production from seabed mining under the Exploitation Contract;
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> (b) where there is a signed letter from the sponsoring State's tax authority stating the actual cash amount paid by the Contractor to the sponsoring State for payments relating to income, profits or production under the Exploitation Contract; and
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> (c) where there is a signed letter from an International Accounting Firm confirming the actual cash amount paid by the Contractor to the sponsoring State for payments relating to income, profits or production under the Exploitation Contract.

The broad definition of Allowable Sponsoring State Payments that are creditable against the Additional Royalty in the Hybrid may also inadvertently allow for the crediting of SOE's dividend payments. In contrast, the payments that are creditable against the Top-up Profit Share in the Hybrid refer to Covered Taxes, which would mean that SOE's dividend payments are not creditable against the Top-up Profit Share.

Going forward, if the Equalization Measure Working Group confirms that the policy intention is for SOEs' dividend payments to not be creditable, then minor redrafting of the Draft Equalization Measure Standard is required to provide for this policy.

Are state Contractors liable for the equalization measure?

It is highly unlikely that any of the Member states that are currently party to exploration contracts would wish to undertake commercial mining under an exploitation contract as this

may expose them to unlimited liability and substantial reputational risk. Rather, a Member state would likely transfer the license to a SOE or private company prior to starting commercial mining to limit its liability. Thus, the question 'are state contractors liable for the equalization measure' is likely moot.

However, if a Member state was party to the exploitation contract it would thus fall under the definition of a Contractor. As a Contractor, the Member state would be liable for the equalization measure as it is for the base royalty, albeit the practical application of the Equalization Measure Audit and reporting of profits may be challenging.

A Member state Contractor would have little to credit against the Additional Royalty, Top-up Profit Share, or Additional Profit Share as:

- states do not pay taxes or dividends to themselves; and
- the definitions of 'Covered Payment' and 'Allowable Sponsoring State Payment' refer to payments to sponsoring states and for Member state Contractors there is no sponsoring state.

Member state Contractors may thus be liable for significant payments to the ISA under the equalization measure. This is in concert with the purpose of the equalization measure, which is to ensure similar effective tax rates between land-based miners and deep-seabed miners regardless of tax rates, tax exemptions, subsidies and the status (SEO, Member state or private company) of the Contractor.

Is, and if so should, the Enterprise be liable for the equalization measure?

If the Enterprise is party to an exploitation contract it would fall under the definition of a Contractor that is provided in the Schedule of the draft Exploitation Regulations. As a Contractor, the Enterprise would be liable for the base royalty and equalization measure. As the Enterprise would not be making payments to a sponsoring state, it would have no or little payments to credit against the equalization measure, and so its equalization measure liability may be significant.

It should, however, be noted that at times both UNCLOS and the draft Exploitation Regulations include sections with terms such as 'Contractors or the Enterprise', which would imply that the term 'Contractor' does not include the Enterprise. It may, therefore, be necessary to amend the draft Exploitation Regulations to provide clarity on whether the term 'Contractor' does or does not encompass the Enterprise.

Regardless of whether the base royalty and equalization measure, both of which are levied on the Contractor, do or do not apply to the Enterprise, there is the question as to whether the equalization measure should be levied on the Enterprise?

The equalization measure aims to ensure similar effective tax rates between land-based miners and deep-seabed miners. This rationale speaks to the Enterprise being liable for the equalization measure. On the other hand, given that they are stakeholders in the Enterprise and that its profits should benefit humankind, states with significant land-based mining may consider that the Enterprise paying a lower effective tax rate than land-based miners is acceptable. This is a matter where further discussion by Member states is required.

In addition, UNCLOS Annex IV Article 10 arguably speaks to the Enterprise being exempted from both the base royalty and the equalization measure for the sooner of 10 years from the date that the Enterprise starts commercial production or it being self-supporting.

The term 'self-supporting' is not defined in UNCLOS or defined (or used) in the draft Exploitation Regulations. One interpretation of 'self-supporting' would be when the Enterprise is no longer reliant on the ISA or Member states for financing. This may be before its starts commercial production as the Enterprise may be able to raise significant debt financing after being granted an exploitation contract but prior to starting commercial production. In such case, there may be no need to exempt the Enterprise from the base royalty or the equalization measure as they would only apply after the Enterprise starts commercial mining.

Another definition of self-supporting is that it occurs when the Enterprise can finance its operations from its profits. If this definition is favoured, then it may be necessary to exempt the Enterprise from the base royalty, but not the equalization measure (as this measure is principally levied on profits).

Given that the matters of whether the Enterprise is, or is not, a Contractor and whether it should or should not be provided with an explicit exemption from the payment regime affect the base royalty as well as the equalization measure, these issues are arguably beyond the remit of the Equalization Measure Working Group. This is especially the case as resolving these matters may require amendments to numerous sections of the draft Exploitation Regulations.

4. Is, and if so should, an Enterprise joint venture be liable for the equalization measure?

The question as to whether an Enterprise joint venture would be liable for the equalization measure is difficult to answer due to the uncertainty concerning the legal personality that such a venture would take. Currently there is no Enterprise joint venture, and both UNCLOS and the 1994 Implementation Agreement are largely silent on the legal personality of such ventures.

An incorporated joint venture is a common form of joint venture. This would involve the Enterprise and its partners creating a new legal entity (e.g. a limited liability company) specifically for the joint venture. The incorporated joint venture would be legally distinct from the Enterprise and could enter contracts, own assets, and incur liabilities in its own name.

The incorporated joint venture would be party to the exploitation contract with the ISA, and as such would be classified as a Contractor. As a Contractor, the joint venture would be liable for the equalization measure against which its tax and royalty payments to its sponsoring state would be creditable[6].

There is a question as to whether the payment regime exemption provided to the Enterprise under UNCLOS Annex IV Article 10 would apply to an incorporated joint venture. As an incorporated joint venture is legally distinct from the Enterprise, there is a strong argument that it would not be exempted from the base royalty or equalization measure.

The Enterprise could also enter an unincorporated joint venture. Under this arrangement the joint venture does not have its own legal personality and is instead based on a contractual arrangement (a joint operating agreement or similar) between the parties. In

[6] Our view is that UNCLOS and the draft Exploitation Regulations would require a joint venture to be sponsored by a state party.

an unincorporated joint venture, it is common for one of the partners to be designated as the operator of the mine.

The draft Exploitation Regulation's silence on unincorporated joint ventures makes it difficult to know with certainty whether the operator only, or all joint venture partners, would be classified as Contractors. If only the operator is a Contractor, then it would be liable for the equalization measure in its sponsoring state on all the income, costs and profits from the unincorporated joint venture. In the alternate that all unincorporated joint venture partners are classified as Contractors then they would all be liable for the equalization measure in their sponsoring state, but only on their share of the joint venture's costs, income and profits.

As can be seen from the above discussion, there is complexity and uncertainty regarding how joint ventures involving the Enterprise would work in practice. However, the source of this complexity is not the Equalization Measure Draft Standard, but rather the relative silence on Enterprise joint ventures in the draft Exploitation Regulations.

Conclusion

1. The Hybrid is penalising Contractors that have been subsidised: not providing them with a subsidy. In addition, the Subsidies Agreement only prohibits certain subsidies. Hence, there is no need to remove the reference to tax exemptions and subsidies from the Hybrid.

2. SOEs are liable for the equalization measure. The wording of the Equalization Measure Draft Standard, however, arguably allows for their dividend payments to be creditable, which was likely not the intention of the Equalization Measure Working Group and is not in concordance with the purpose of the equalization measure. A minor redrafting of the Equalization Measure Standard can resolve this matter.

3. It is highly unlikely that any Member state would wish to directly be party to an exploitation contract and undertake commercial deep-seabed mining due to the unlimited liability and reputational risk involved. Nevertheless, as drafted, the equalization measure does apply to state Contractors.

4. As the draft Exploitation Regulations and Equalization Measure Draft Standard are currently written the Enterprise appears liable for the base royalty and the equalization measure. This arguably contradicts the payment regime exemption provided to the Enterprise under UNCLOS Annex IV Article 10. On the other hand, that exemption is only provided for a period. This period is the lesser of ten years from the Enterprise starting commercial production and it becoming self-sufficient. The equalization measure will very likely, and the base royalty may, not result in the Enterprise having to make a payment to the ISA until after this period. As such, there is a question as to whether the draft Exploitation Regulations need to be amended to explicitly exempt the Enterprise from the base royalty and equalization measure for this period.

5. The draft Exploitation Regulations' silence on the legal personality of Enterprise joint ventures creates a degree of uncertainty regarding how the equalization measure would apply to such ventures. However, our view is that an Enterprise incorporated joint venture should, and would, be liable for the equalization measure. While for an Enterprise unincorporated joint venture either the operator or all parties to the joint venture would be liable for the equalization measure.

Suggested actions for the Equalization Measure Working Group

1. To amend the Equalization Measure Draft Standard text to provide clarity that a SOE's dividend payments are not creditable.

2. To raise for further discussion by the Council the matters of - a.) the possible exemption of the Enterprise from the base royalty and equalization measure for a period and b.) the relative silence of the draft Exploitation Regulations on the legal form of Enterprise joint ventures.