

# EXECUTIVE COUNCIL

## CONFIDENTIAL

**Title:** Extra Statutory Concession

**Paper No:** 156/12

**Date:** 27 June 2012

**Report of:** Commissioner of Taxation / Director of Mineral Resources

---

### **1. Purpose**

- 1.1 To consider the introduction of an Extra Statutory Concession to facilitate the deferral of corporation tax on capital gains in certain circumstances.

### **2. Recommendation**

- 2.1 It is recommended that Executive Council approve the introduction of ESC 16 which is attached to this paper.

### **3. Summary of Financial Implications**

- 3.1 None

### **4. Background**

- 4.1 The current Falkland Islands tax legislation contained in the Taxes Ordinance 1997. Policy in respect of taxation of the oil and gas industry was developed in the 1990s and the application of certain parts of this legislation to the oil and gas industry has never been tested due to a lack of success in the 1998 drilling round.
- 4.2 The Taxes Ordinance 1997 provides for taxation of capital gains for certain elements of the offshore oil and gas industry and specifically the capital gain in respect of licence assignments.
- 4.3 Such licence assignments, commonly known as farm-outs in the oil and gas industry, operate by the original licence holder assigning (farming out) a percentage of its interest in the licence to a third party (the farmer-in) in return for a consideration. Such consideration may include a cash payment, a promise to pay forward costs for further exploration, appraisal or development work (also known as a 'carry'), or both. If the consideration includes a 'carry' the

farmer-out therefore has the benefit of being 'carried' in future work programmes which is a taxable benefit.

- 4.4 In the event that such licence assignments carry a non-cash consideration in respect of a 'carry' for development costs, a tax charge arises on this consideration which is ordinarily payable in the current accounting period. Under the Taxes Ordinance 1997, no provision exists for deferring tax liabilities.
- 4.5 In the event of a significant 'carry' from a farmer-in forming part of the licence assignment and therefore being subject to a tax charge, it is possible that a farmer-out may not have sufficient funds available to pay the tax charge at the time it arises. FIG consider that this is unreasonably restrictive and might act against the national interest by restricting some available development options that may arise for successful oil and gas fields.
- 4.6 The Commissioner of Taxation has proposed an Extra Statutory Concession as a means of deferring the payment date of certain elements of corporation tax on the chargeable gain due under the above scenario for up to five years. The practical effect of this is to defer the due date of the tax liability arising in respect of the carry element of a farm in until the beginning of oil or gas production or five years whichever is earlier.
- 4.7 The proposed ESC does not defer any liability in respect of a cash consideration paid in respect of a licence assignment, which becomes due on receipt of the cash consideration, nor does it affect the overall tax charge in respect of such assignments.
- 4.8 The policy contained in this ESC will be considered as part of the current work ongoing within FIG to review various items of legislation in relation to developing the petroleum industry.

## **5.0 Financial implications**

- 5.1 Deferral of Corporation Tax liability would impact the timing of capital gains tax receipts by the Tax Office and any investment income that would derive from increased FIG reserves

## **6.0 Legal implications**

- 6.1 None

## **7.0 Human resources implications**

- 7.1 None

Attachments: Appendix 1: ESC 16

## Appendix 1: ESC 16

### Deferral of date when tax is due for farm in and carry agreements

Where a seller, prior to commencement of petroleum production from this or any other licence, makes a part disposal of a licence which accrues a chargeable gain under Section 141 Taxes Ordinance 1997 and the receipt includes a non cash element the payment of the tax charged on the disposal of the licence can be deferred as below.

The gain on the disposal will be calculated on the basis of the total consideration received and the corporation tax liability calculated on this gain. The tax will then be divided between the cash and non cash elements on the basis of the proportion that each bears to the total consideration received.

For the tax on the cash consideration received, deferral of payment will be to the earliest of

- Receipt of the cash amount
- 'First oil' production from the licence interest disposed of
- Five years from the date of the disposal contract

For the tax on the non cash consideration, payment will be due at the earliest of

- 'First oil' production from the licence interest disposed of
- Five years from date of disposal contract

In all cases payment of the deferred tax must be made by the later of the normal due date and 30 days from the date to which the charge has been deferred.

#### *Example*

Truman Limited has incurred £320m exploration costs eligible for depreciation allowances under Section 111(1) Taxes Ordinance 1997. Boycott Limited farms in for part of the licence for a cash reimbursement of £200m for historical costs and a development drilling agreement which is considered to have a net present value of £400m. Under Schedule 2 Para 1(4) Taxes Ordinance 1997, Truman claims the balance of expenditure eligible under Section 111 which has not passed over to Boycott against the chargeable gain.

Assuming no other allowable base costs, the chargeable gain is:

	£m
Total consideration £200m + £400m	600
Less Schedule 2 Para 1(4) costs £320m - £200m	<u>(120)</u>
Gain	<u>£480</u>
Corporation tax due at 26%	<u>£124.8</u>
Tax on cash consideration £124.8 x 200/600	<u>£41.6</u>
Tax on non cash consideration £124.8 x 400/600	<u>£83.2</u>

### Explanation

Petroleum exploration and production is a relatively new industry in the Falkland Islands and the tax legislation dealing with it is mostly untested.

This ESC applies to a 'farm in' or 'carry' transaction where the consideration is not received immediately and/or not received wholly in cash.

There is a tax charge on the profit made on disposing of a licence and this includes farm in and carry contracts. The tax charged is based on both the value of the work programme envisaged and any other consideration, including cash paid to reimburse the seller's previous expenses. However, because some of the tax charge is based on an amount where no money has been received by the seller there can be situations where the seller has insufficient funds to pay the tax. This ESC therefore defers the payment of the tax for a limited period in such situations.

This relaxation in allowing deferral of the due date for payment of tax will be kept under review and may be withdrawn if it appears to be abused.