

# CONFIDENTIAL

PUBLIC

## EXECUTIVE COUNCIL

**Title:** Oil Related Matters

**Paper No:** 175/14

**Date:** 27 August 2014

**Report of:** Commissioner of Taxation/Financial Secretary

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### **1. Purpose**

- 1.1 To consider the amendment of Extra Statutory Concession 16 (ESC 16) to further facilitate investment within Falkland Islands hydrocarbon fields.

### **2. Recommendations**

- 2.1 It is recommended that Executive Council approve:
- a) the amendment to ESC 16 (Appendix A) to allow partial (not substantial) disposals of a hydrocarbon licence;

### **3. Additional Budgetary Implications**

- 3.1 None

### **4. Background**

- 4.1 ExCo 156/12 and 07/14 introduced ESC16 which allowed for the deferral of an element of the tax payable on the gains arising from the sale of hydrocarbon licences. To ensure that FIG was not left at too high a risk, the latest amendment to this ESC 16 (07/14) contained a number of anti-avoidance measures. Firstly, any company wishing to take advantage of the ESC is required to enter into a formal agreement with FIG. This is purely to ensure that FIG's interests in the matter are protected. The second area introduced in the amended ESC was to protect FIG against any further sale of the licence which may leave the seller with a reduced interest in Falkland Islands development.

### **5. ESC16 amendment**

- 5.1 ESC16 includes an anti-avoidance clause that means that if a company takes advantage of the ESC16, thereby deferring payment of tax on any deferred

considerations, and subsequently sells all or part of its remaining interest in the licence the tax becomes payable immediately. The purpose of ESC16 is to encourage continued investment in Falklands hydrocarbon developments by not placing a financial burden on companies prior to value being received, either through sale of the licence or production of oil.

- 5.2 However, this clause, whilst protecting FIG, has potentially resulted in an unintended barrier to development. By referring to “all or part” disposals any subsequent partial sale of a licence, for example in order to encourage a third investor into a field development, would result in an immediate taxation payment being required. It is not the intention of the ESC to create barriers to investment and therefore an amendment is now proposed in case this should inadvertently prevent development.
- 5.3 It is proposed that the word “substantial” is added to the relevant clause (as shown below). This would enable FIG to assess whether a subsequent sale is in the interests of the Islands as a whole and enable favourable sales to progress. It is anticipated that this would be undertaken as part of FIG’s approval of any licence sale.

*ESC16 extract: The date on which the seller otherwise realises value from the licence (including, without limitation, the date on which cash or non cash consideration is received on a pre-sale of oil or a subsequent disposal of all or a substantial part of the seller’s remaining interest in the licence).*

- 5.4 It is difficult to define what “substantial” means as each farm out will be different. However, the intention is that this is assessed so that the remaining licence does not fall below a level that indicates the intention of the original licensee to continue development in the Islands. This is based on the principle that the purpose of the ESC is to allow the company to retain cash to put into the development rather than pay tax. If this is not the case then the tax should be paid immediately.
- 5.5 It is proposed that the ESC is further amended to require companies wishing to take advantage of it to reach an agreement with FIG within 60 days of notifying FIG they wish to take advantage of the ESC. The revised ESC is shown in Appendix A.

## **6.0 Financial implications**

- 6.1 No direct financial implications.

## **7.0 Legal implications**

- 7.1 The change to the ESC proposed would become effective from 28<sup>th</sup> August 2014.

## **8.0 Human Resources implications**

- 8.1 None

## **Appendix A: Revised ESC16** **(Amendments shown in blue)**

### **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 of all or part of the consideration is deferred, the payment of the tax charged on the disposal of the licence may be deferred as below, subject to a formal written agreement being entered into between the taxpayer and the Falkland Islands Government (FIG).

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, and the deferred and non deferred elements, on the basis of the proportion that each bears to the total consideration received.

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

- Receipt of the cash amount
- The date on which the royalty is due on 'first oil' production from the licence interest disposed of
- The date on which the seller otherwise realises value from the licence (including, without limitation, the date on which cash or non cash consideration is received on a pre-sale of oil or a subsequent disposal of all or **a substantial** part of the seller's remaining interest in the licence)

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

- The date on which the royalty is due on 'first oil' production from the licence interest disposed of
- The date on which the seller otherwise realises value from the licence (including, without limitation, the date on which cash or non cash consideration is received on a pre-sale of oil or a subsequent disposal of all or **a substantial** part of the seller's remaining interest in the licence)

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.

To benefit from this deferral, taxpayers will be required to enter into a formal written agreement with FIG. This relaxation to allow deferral of the due date for payment of tax will be kept under review and may be withdrawn if it appears to be abused. FIG may also require additional specific terms to be entered into **within 60 days** to secure the payment of the deferred tax and to protect itself from the avoidance of tax.

### *Example*

Truman Limited has incurred £320m exploration costs eligible for depreciation allowances under Section 111(1) Taxes Ordinance 1997. Boycott Limited farms in 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 part disposal of a licence which accrues a chargeable gain under Section 141 Taxes Ordinance 1997 where the consideration is not received immediately.

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 or other benefit has been received by the seller there can be situations where the seller has insufficient funds to pay the tax at the time it arises or where payment of the tax would reduce the funds available for future development within the Falkland Islands. This ESC therefore allows the taxpayer to enter into an agreement with FIG to defer the payment of the tax in such situations.