EXECUTIVE COUNCIL

PUBLIC

Title:	Oil Taxation – Conclusions from public consultation
Paper Number:	121/18
Date:	29 August 2018
Responsible Director:	Financial Secretary
Report Author:	Head of Tax
Portfolio Holder:	MLA Roger Spink & MLA Roger Edwards
Reason for paper:	This paper is submitted to Executive Council: For policy decision For policy update/information
Publication:	Yes with redactions highlighted in grey Not Recommended: *Under Executive Council Standing Order 23(2), Executive Council must have regard to the categories of exempt information in Schedule 3 to the Committees (Public Access) Ordinance when determining if information should be withheld* *The categories which are potentially relevant to this paper are:* Paragraph 9*:* Information about others' financial and business affairs
Previous papers:	152/17 Sea Lion Update 09/18 Oil Taxation – Issuing a consultation document
List of Documents:	Appendix 1: Consultation responses summary (redact)

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1. Recommendations

1.1 Honourable Members are recommended to:

(a) Note the changes made in approach arising from the consultation outlined in Section 5 below

(b) Note the progress of work towards draft legislation by Freshfields Bruckhaus Deringer LLP (‘Freshfields’) for Government Legal Services, to be incorporated into a draft Taxes Amendment Ordinance”?

2. Additional Budgetary Implications

2.1. None

3. Executive Summary

3.1. The ‘Open for Investment’ consultation on oil taxation matters (ExCo paper 09/18) closed in April 2018. Responses have been evaluated, with assistance from Freshfields. We are now in a position to make firm recommendations in all areas.

3.2. The main areas for consultation were:

1) Section 4: The timing and quantum of Corporation Tax deductions for finance and interest charges arising in relation to oil activities – a proposed new fixed ratio interest barrier.
2) Section 5: The timing and quantum of Corporation Tax deductions for plant and machinery used in relation to oil activities acquired through hire purchase contracts – proposed new hire purchase rules.
3) Section 6: The quantum of Corporation Tax deductions that are allowable for the leasing of plant and machinery used in relation to oil activities – a proposed hire cap mechanism.
4) Section 7: The Corporation Tax relief available in relation to decommissioning expenses, where these are carried back and set against taxable profits for earlier periods.

3.3 Seven responses were received, although not all addressed each issue. Industry responses to the consultation were received from holders of petroleum licensees, companies who have operated in the supply chain providing oilfield services in the last exploration campaign (2015-16), professional services firms and the main representative body, FIPLA.

3.4 A summary of the responses, which have been anonymized (and will be redacted prior to publication), is attached at Appendix 1.

3.5 The final draft legislation to be submitted to the Legislative Drafter in Government Legal Services is in progress and will incorporate the recommended changes detailed in Section 5 of this paper.

3.6 A further ExCo paper is expected (September 2018) which will cover the related issues of tax clearances for the Sea Lion Phase 1A development. Recommended changes to Schedule 6 and tax administration reform will form a third ExCo paper. The timing of the third paper is dependent on FIG receiving and reviewing proposals from the Operator of Sea Lion, Premier Oil which must then be reviewed by FIGTO.

3.7 FIG’s objectives remain as stated in the consultation document - to ensure our tax regime secures a fair proportion of the profitability arising from oil exploration and development within our waters, for the benefit of Islanders; that it is sufficiently internationally competitive to attract capital investment from overseas; and that it is stable and provides certainty both for FIG and the taxpayers. We believe that this will be achieved via the forthcoming legislation and accompanying guidance.

4. Background and Links to Islands Plan

4.1 See paper 09/18 for detail and background on the benefits of consulting publicly on the future of the oil taxation regime - especially with regards to certainty and transparency for the investor and in order to reduce any ‘fiscal risk’ premium currently attached to an undeveloped oil regulatory and tax regime in a frontier hydrocarbon province.

4.2 The ‘Open for Investment’ consultation ran for 6 weeks, closing on 6th April 2018. A total of 7 responses were received from the following entities:

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4.3 Encouragingly, respondents had an overall positive response to the approach of the FIG consultation and follow up discussions with a few of them have clearly demonstrated that respondents welcomed the opportunity to comment on and shape proposals.

4.4 As expected, respondents were less positive about the proposals that will, or could be expected to, increase the direct tax burden on their companies. Some respondents expressed a preference for options which the consultation document had explained would be unacceptable to FIG. For example, some respondents advocated for transfer pricing for leasing contracts (discussed at 5.3 below) which FIG does not support as it believes they would be difficult to enforce and likely to deliver minimal tax revenues on otherwise profitable activities in our waters.

4.5 Specific key issues were targeted via direct consultation questions. Where alternative (but in overall terms, acceptable to FIG) suggestions were made, and accompanied by good supporting arguments or evidence, these have been largely accepted. See Section 5 for full details.

4.6 One of the key themes of the new Islands Plan (2018-2022) concerns economic development in relation to hydrocarbons. A number of points are relevant to this paper, including the desire to ‘create attractive conditions to facilitate external investment for existing and new hydrocarbons projects’ and ‘create a robust legislative framework to facilitate and regulate hydrocarbons development…’. The recommendations in this paper are expected to secure these outcomes in relation to the taxation of the future hydrocarbons industry in the Falkland Islands.

5. Options and Reasons for Recommending Relevant Option

5.1. <u>Interest/financing</u>

5.1.1 An interest barrier modelled on international best practice - contained within the OECD BEPS[1] Action 4[2] - has been proposed. Most respondents who commented on

[1] Base Erosion and Profit Shifting

[2] http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm

the interest barrier agreed that if this approach was FIG's preferred option, then selecting a maximum deduction of 30% of tax EBITDA[3] was appropriate.

5.1.2 One respondent suggested FIG introduce a group ratio (in which the finance deduction is capped by reference to group debt, rather than the taxpaying entity's EBITDA) in addition to the fixed ratio, to help companies with high levels of external debt across their worldwide group. The introduction of a group ratio in addition to the fixed ratio has been considered but was discounted because it would bring substantial additional complexity into the regime and doesn't appear to be relevant to current oil licensees with the Basin.

5.1.3 We also asked whether our view of what is captured as a 'finance charge' was accurate. A number of respondents wanted FIG to exclude from the interest barrier the fees for obtaining Letters of Credit (a bank instrument commonly used to fund decommissioning security trusts), based on UK Supplementary Charge rules. We considered this but discounted the suggestion because these fees are equivalent, in all but name, to a cost of obtaining finance and it would seem inconsistent to exclude them. We have received no evidence that including them would have a material (adverse) impact on development viability. This point should however be revisited in the future when decommissioning is better understood in a Falklands context, such as when the Letters of Credit are required to be provided into the decommissioning security trust fund.

5.1.4 All respondents agreed that the definition of tax EBITDA for the fixed ratio was appropriate.

5.1.5 FIG suggested introducing a 'de minimis' to the operation of the fixed ratio, of £100,000 per annum. This means that the fixed ratio does not apply to relatively small (in absolute terms) amounts of debt interest. We asked in the consultation if respondents felt that this was set appropriately. We had a number of respondents suggesting that this allowance was not high enough to be appropriately targeted at levels of debt suggestive of aggressive tax planning. Upon reflection we have decided to increase the de minimis to £500,000 per annum, which we feel strikes an appropriate balance. One respondent suggested it should be uprated by RPI inflation annually, which we have rejected on the basis that it would add unnecessary complexity. The amount of the de minimis should however be reviewed in future to make sure it continues to be appropriate.

5.1.6 As a result of the proposed fixed ratio linking deductibility of interest expense to tax EBITDA, there may in some periods be insufficient tax EBITDA to ensure that interest expense is usable, but a surplus (of tax EBITDA) in later years. The consequence of this is that variable earnings and interest expenses could remain unrelieved even if across a project's lifecycle the amount of interest expense would be considered reasonable. This bumpiness can be avoided by allowing a carry forward of unused interest expense to later years and FIG originally proposed that this was set at 3 years. Most respondents claimed that this period was too short and suggested an

[3] Earnings Before Interest Taxes Depreciation and Amortisation, the calculation of which is set out in the draft legislation (s 155A) – taxpayers will not be permitted to use the EBITDA figure shown in their financial statements/accounts.

indefinite carry forward period is built in to the legislation. Upon reflection we recommend that the carry forward should be set at 5 years to make reasonable allowance for project overruns and other factors, but that an indefinite period should be rejected.

5.1.7 In some instances there can be an overlap between the fixed ratio interest restriction and the leasing rules (at 5.3 below), where the part of a lease payment that is deemed to be equivalent to a loan could be restricted by both the hire cap <u>and</u> the interest barrier rules. Where this is the case, FIG has suggested that there is a pro rata between the capital and interest elements of the lease, so that the interest element is taken into account in the interest barrier calculation. FIG feels that this is the fairest way to avoid a 'double' restriction being applied to the same expense. Respondents preferred any disallowance under the hire cap rules to be allocated wholly to the capital element, effectively meaning no restriction of interest would be applied. This has been rejected because FIG was not persuaded by the principles-based argument and no supporting evidence accompanied the representations.

5.1.8 Respondents are keen to engage with FIG in designing the information returns to support the interest barrier, which is appreciated. One respondent pointed out that if all debt interest falls within the de minimis allowance then no return ought to be required - a point that we have accepted and which will be mentioned in guidance.

5.2 <u>Hire Purchase</u>

5.2.1 FIG are looking to introduce specific tax provisions for assets acquired under 'Hire Purchase' contracts rather than 'traditional' leasing or outright purchase. Under these contracts payments are made over time and legal ownership transfers to the payer upon completion.

5.2.2 Limited use has been made of HP in the past, and as such no specific tax provisions currently exist within the Taxes Ordinance. FIG expect this to change in the future so are looking to introduce specific clauses into legislation to deem the payer under a hire purchase contract to be the legal owner of the asset from the outset of the contract with Depreciation Allowances being available as payments are made.

5.2.3 All respondents who commented on the hire purchase questions said that they support the introduction of specific hire purchase tax provisions as a general policy approach. All respondents also agree that rules should be introduced for all classes of asset that current attract depreciation allowances, including vehicles and ships.

5.2.4 Whilst all respondents seem to agree with the way FIG have defined hire purchase contracts a number of respondents request guidance to help interpret the rules. FIG will be drafting supporting guidance in a number of areas, including this one.

5.3 <u>Leasing</u>

5.3.1 This area proved the most contentious, as FIG expected. All respondents wanted FIG to revert to old transfer pricing methodology with regards to leases - this methodology, however, can be exploited to minimise a group's corporation tax liability within the Falklands. Transfer pricing rules are also difficult and expensive to enforce. This was therefore not an option presented in the consultation.

5.3.2 However, FIG has listened to feedback from Industry. FIG explained that it was willing to repeal the 2015 legislation changes (s. 152A(5) allowed no relief whatsoever for intragroup leasing). In its place, the consultation document proposed a quantifiable amount of relief that would be available. FIG felt that this offered an appropriate and proportionate response to the BEPS (base erosion and profit shifting) risks FIG face in this area.

5.3.3 FIG also proposed, given the lack of transitional provisions put in place when the 2015 amendments were introduced, that the new rules should apply retrospectively from 1 October 2015. After careful consideration, FIG recommend this approach is legislated as it gives an appropriate level of relief for companies from 2015 onwards, is quantifiable for investor certainty, and should provide a firm basis to settle outstanding cases.

5.3.4 Applying the new rules from 1 October 2015, as proposed, will mean that it will apply to contracts entered into before that date, in place of the current leasing restriction in section 152A. An alternative approach could be to remove the current leasing restriction at s.152A and apply the replacement hire cap applicable for only contracts entered into on or after 1 October 2015. However, that approach would mean the contracts entered into for the 2015/16 exploration campaign would be subject to neither the current or proposed leasing restriction. This approach would likely result in negligible tax yield from the vast majority of contracts awarded and undertaken in the 2015/16 exploration round. Existing tax rules may not be apt to ensure that a fair amount of profits from the 2015/16 exploration campaign are taxed in the Falkland Islands. Therefore, the recommendation is to implement the new rules, in place of the old rules, effective from 1 October 2015 (including in relation to payments made on or after 1 October 2015 under contracts entered into before that date).

5.3.5 When asked for reflections on the proposed mechanics of the hire cap, some respondents did not appear to appreciate that the percentage rate of relief of 7.5% would be a minimum value, and higher relief would be available for assets that can be demonstrated to have a shorter useful economic life than the current assumption of 20 years, upon application to the Commissioner of Taxation. FIG proposes that this is made explicitly clear in the accompanying guidance. One respondent claimed that the 7.5% default rate was too low but FIG does not recommend that the percentage is increased across the board because no substantive evidence was presented that would support a higher rate across the board.

5.3.6 Another detailed point concerned the test for being ‘associated’ for the purposes of the hire cap, which was borrowed from the UK equivalent. FIG recommends that this test is explained further in guidance and a company can seek permission on a case by case basis to apply the test only to companies with whom it is connected within the lifetime of the lease. This should remove the need check ‘association’ by reference to long corporate histories to check for the existence of a very historic connection which is no longer relevant for BEPs risk.

5.3.7 Further clarificatory guidance will be provided to clarify contracts that are captured by the leasing hire cap, because there was some misunderstanding of our intention, although the majority were broadly content with our approach.

5.3.8 Industry's request for an (exhaustive) list of asset types for which the hire cap applies would be very difficult for FIG to compile (and it would be undesirable for the list to be exhaustive in any case). FIG recommends that industry be invited to compile an illustrative list of asset types for consideration within the accompanying guidance.

5.3.9 In order to target the hire cap at the highest value (and therefore greatest BEPS risk) assets, FIG suggested a de mininis market value, under which assets would not be caught by the hire cap. A figure of £2,000,000 was suggested in the consultation. Some respondents agreed with this level, but others argued (without substantive evidence) that the de minimis ought to be higher. FIG recommends that the de minimis value for £2m is maintained.

5.3.10 However, to exclude from the hire cap assets which spend a very short period under a lease agreement within the Falkland Islands designated waters, FIG recommends that the legislation provides for a second de minimis based on time spent within the zone in any one period. This would mirror provisions for the determination of a permanent establishment within the UK-FI Double Taxation Agreement - 30 days in any one 12 month period. It could be especially relevant for assets which are brought into the area to assist with one-off activities such as the hook up and commissioning of the FPSO or a well maintenance job during the production phase. The time period for this temporal de minimis could be reviewed in future and taxpayers could apply for special dispensation if they are inadvertently within the zone for more than this time period due to factors outside their control such as weather windows.

5.4 Decommissioning

5.4.1 This section of the consultation was deliberately written in more general and non-specific terms, inviting evidence related to decommissioning loss carry back periods and posing questions about whether the current 3 year rule was sufficient to provide relief for abandonment costs.

5.4.2 Persuasive policy arguments were made for the removal of the time limit within which decommissioning must be carried back after a company ceases to trade (currently 3 years), and this change is recommended within the legislation, via discretion given to the Commissioner of Taxation to authorize a longer period beyond the statutory 3 years. Making this change will remove the urgency to decommission the facilities quickly after production (and therefore trade) has ceased - this is likely to deliver a better outcome in terms of safety and protection of the environment and also reduce cost inflationary pressures that could otherwise arise at the end of the asset's life.

5.4.3 In addition to the point above, the current Ordinance provides for a strict time limited period within which decommissioning costs can be carried back and generate refunds of prior tax paid. This is currently limited to 3 years. Respondents wanted FIG to copy the UK approach and make this very much more generous (unlimited carry back was mentioned by respondents).

5.4.4 Evidence provided to FIG indicates that unlimited carry back is not required to achieve full relief, assuming projects are delivered on time and on budget; extending the carry back window to between 8 and 10 years provides full relief. On the basis that there is a large amount of uncertainty about the timing of decommissioning, the costs involved and profitability in the period immediately prior to decommissioning FIG recommend that the loss carry back for decommissioning relief is extended to a fixed 5 year period (from the current statutory position) with the position reviewed nearer the time when there is more certainty about the economic effects of further extensions beyond this point.

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5.4.6 FIG also recommends the publication of guidance to clarify that the definition of 'decommissioning expenditure' would be interpreted in line with UK rules (which have been recently been updated, after consultation with taxpayers).

5.5 <u>Other miscellaneous issues</u>

5.5.1 The consultation had two open questions which invited miscellaneous comments from respondents. In this section, a number of unrelated issues were raised which are summarised below. For most of these, no further action is required or recommended at the current time, or the issues raised will be addressed in accompanying guidance.

5.5.2 One respondent requested guidance clarifying the territorial scope of the FI tax regime. This is recommended to be introduced to accompany the leasing hire cap, to make it clear that a bareboat charter lease alone is not expected to trigger an FI permanent establishment. This will help to clarify a relatively technically complicated area of the Taxes Ordinance 1997 and should give investors certainty about the circumstances in which a FI taxable presence is created.

5.5.3 Corporate restructures and any associated corporate chargeable gains issues were also mentioned in this section. These are well understood within FIG and are outside the scope of the consultation but had been raised indirectly in one response. No direct action is recommended because any future case will depend on the specific facts of the matter.

5.5.4 A number of administrative issues around Schedule 6 powers have been mentioned by one respondent and these will be the subject of a separate ExCo paper in September, so no recommendations have yet been formulated.

6. Resource Implications

6.1. <u>Financial Implications</u>

6.1.1 No additional financial implications except those noted above in Section 5.4.5.

6.2. <u>Human Resource Implications</u>

6.2.1 None

6.3. Other Resource Implications

6.3.1 None

7. Legal Implications

7.1. Draft legislation formed a key part of the public consultation paper and has been revised by Freshfields to reflect the above recommendations. This will form the basis of specialist legislative drafting resource which has been identified in 2H 2018 for enactment prior to the end of 2018. This timing supports the Final Investment Decision of the Sea Lion development due at end 2018.

7.2. The recommendations do not fetter any fundamental rights or freedoms under the Constitution or public decision making.

8. Environmental & Sustainability Implications

8.1. None

9. Significant Risks

9.1. Delivery of updated legislation is required by the end of 2018, in line with a possible Final Investment Decision on the Sea Lion field phase 1A in the North Falkland Basin.

10. Consultation

10.1. This paper summarises the responses of the public consultation conducted between February and April 2018.

10.2. The recommendations have been discussed at Strategic Oil Group, with the Financial Secretary and Director of Mineral Resources in relevant areas and with the Portfolio Holder for Tax and Fiscal Policy, Roger Spink MLA.

11. Communication

11.1 By making this ExCo paper public interested parties, including consultation respondents can see the areas where their responses have informed an amended approach from FIG and the reasons why comments have not been actioned in other areas.

11.2 FIG will be engaging with the industry via FIPLA and companies who have offered to contribute to guidance alongside the drafting and enactment of the legislations is relevant areas.