

REVIEW OF THE PETROLEUM MINING INCOME TAX REGIME

A Hedge
Rudd Watts & Stone

R J Cullen
Rudd Watts & Stone

Abstract

The New Zealand regime for taxation of petroleum miners was revised by the Income Tax Amendment Act (No. 2) 1990 and a complete code of deductibility of 'petroleum mining development expenditure' was provided in sections 214D-214N.

The paper will focus briefly on the structure of the new regime and then examine some of the problems which arise in its application. The present government has made statements that the regime will be reviewed and the paper will focus on some suggested changes.

Introduction

You thought capping oil wells in Kuwait was exciting, however, it's nothing compared to the current regime for the taxation of petroleum mining companies.

The regime was enacted in the Income Tax Amendment Act (No. 2) 1990, which was introduced into Parliament on Budget night and received Royal Assent on 1 August 1990.

After initially adopting a consultative process and taking submissions on the first draft of the Bill in Select Committee, it was a stark contrast when the Government enacted a totally redrafted version without any consultation.

The subsequent change of government brought promises of a new regime. In speaking to the Petroleum Exploration Association in November 1990, however, Wyatt Creech, the Minister of Revenue, stated it was 'far too early' to give a time-frame for the new regime which he promised would restore the old system where expenses were deductible in the year incurred. Nearly a year later there is still no sign of change. In the recent Budget the government foreshadowed a review of the Controlled Foreign Corporation and Foreign Investment Fund regime and bilateral agreements between countries. There was no mention of a review of the Petroleum Mining Regime and from that it is unlikely that there will be any change in the near or even distant future given the lack of priority of the matter.

The Current Regime

The current regime for the taxation of petroleum mining companies is codified in Sections 214D to 214N of the Income Tax Act 1976 (Act). Sections 214O to 214P provides for the tax treatment of further development expenditure in relation to the Maui B platform development. Section 214P essentially re-enacts 214B(9) of the old regime which dealt with development and exploration expenditure in relation to the Maui field.

The current law came into effect on 1 October 1990 and provides that exploration costs incurred during the

development of petroleum mining assets (now referred to as Petroleum Mining Development Expenditure) will be capitalised to a cost of licence account. The expenditure will be deductible either on relinquishment of the licence, seal and abandonment, disposal of the petroleum mining asset, or ten years from the start of commercial production.

The regime provides specific treatment for: licence relinquishment (Section 214F(4)(a)); seal and abandonment of an exploratory well (Section 214F(4)(b)); disposal of a petroleum mining asset for consideration (Section 214F(4)(c)); farm-out arrangements (Section 214I); and also for damage of licence specific assets, disposition of shares or trust interests in a controlled petroleum mining entity and for petroleum mining operations carried on outside New Zealand (Sections 214J, 214K and 214M respectively).

This paper provides a working guide to the regime.

What Expenditure Falls Under the Regime

'Petroleum mining development expenditure' is defined in Section 214D(1). It is defined as expenditure incurred by a Petroleum Miner after the date an application for a prospecting licence is submitted with respect to a licence area to the extent that such expenditure is directly attributable to that licence area and is for the purpose of:

- (i) Obtaining or evaluating petroleum prospecting information;
- (ii) Planning, drilling, testing, or abandoning exploratory wells; or
- (iii) Planning, designing, constructing, or acquiring 'licence specific assets' (assets - not including land, exploratory well assets, petroleum prospecting information assets or petroleum licences - acquired by petroleum miners for the purpose of carrying on petroleum mining operations in a licence area or areas and having an estimated useful life which is dependent on and is no longer than the remaining life of the petroleum licence).

It does not include expenditure on:

- (i) The costs of conducting scientific research for which the Commissioner has allowed a deduction under Section 144;
- (ii) An application fee payable to the Crown for a petroleum licence;
- (iii) Insurance premiums;
- (iv) Royalties paid under the Petroleum Act 1937;
- (v) Land tax;
- (vi) Rates;
- (vii) Leases of land or buildings;
- (viii) Financial arrangements as defined in section 64B;
- (ix) Interest.

Given the scope of the definition, all expenditure which relates to the licence area for the purposes specified (excluding the exceptions listed above) will only be deductible on relinquishment of the licence, seal and abandonment, disposal of the petroleum mining asset or over a ten year period when commercial production commences.

What is a Petroleum Miner?

A Petroleum Miner is defined as in relation to a petroleum licence, any person who carried on petroleum mining operations in that petroleum licence area, but does not include any person who carried on such operations for consideration that is not in the form of or contingent on:

- (i) Production of petroleum from that licence area; or
- (ii) Profits from the production of petroleum from that licence area; or
- (iii) An interest or a right to an interest in that petroleum licence.

Capitalisation and Amortisation of Petroleum Mining Development Expenditure

Petroleum mining development expenditure is deemed to be a deferred deduction which will be deductible in equal amounts over the ten income years beginning the later of: the first year of commercial production; or the income year in which the expenditure was incurred (Section 214F(1)(2)).

It is also provided that these deferred deductions in respect of expenditure incurred for the purpose of acquiring a licence specific asset shall be attributable to the asset and expenditure incurred for the purpose of acquiring a petroleum licence or exploratory well asset or a petroleum prospecting information asset is attributable to the petroleum licence with respect to the area to which the asset relates.

Exceptions

There are a number of important exceptions to the amortisation of the capital expenditure over the ten years. These are dealt with below.

Relinquishment of Petroleum Licence

Where a Petroleum Miner relinquishes a petroleum licence any deferred deductions attributable to that licence or to any licence specific asset held solely in respect of that licence are deductible in the year of relinquishment provided that a deduction for the deferred deduction had not already been taken (Section 214F(4)(a)).

Sealing and Abandonment of Exploratory Well

If a Petroleum Miner seals and abandons an exploratory well before the first year of commercial production, the

exploratory well expenditure can be deducted in the year of sealing and abandonment provided it has not been deducted previously (Section 214F(4)(b)). 'Seal and Abandonment' is a defined term (Section 214D(1)). This deduction is not dependent upon the petroleum licence or any part of it being surrendered.

'Exploratory Well Expenditure' is deemed to be petroleum mining development expenditure and is all the expenditure which is incurred by the Petroleum Miner in drilling, testing, completing, and abandoning the exploratory well. It does not include preliminary expenses such as seismic surveys.

There are some formalities to be observed in regard to sealing and abandonment.

Principally, it should be noted that a well is not sealed or abandoned for the purposes of taking the deferred deductions unless the Petroleum Miner files a statutory declaration with the Commissioner of Inland Revenue. The Petroleum Miner has to declare it has no intention of utilising the particular exploratory well in mining operations or of applying for a mining licence in respect of the area in which that exploratory well is located (Section 214D(1)).

A question has been raised as to the meaning of the word 'area' referred to above in the definition of 'seal and abandonment'. The word 'area' does not appear to mean the same thing as 'licence area'. However, there is sufficient ambiguity in the language and in definition to suggest there is potential for dispute.

Disposal of Petroleum Mining Asset

If a Petroleum Mining Asset is disposed of for consideration the deferred deductions are deductible in the year the consideration is assessable to the Petroleum Miner in terms of Section 214H(1). This only applies to the deferred deductions which are attributable to the Petroleum Mining Asset (Section 214F(4)(c)).

Where the asset is disposed of for consideration and partly excess expenditure, then the provision only applies to that part of the asset excess expenditure. This is not the easiest of provisions to understand. Petroleum Mining Assets disposed of partly for consideration and partly for excess expenditure can only occur in the context of a farm-out arrangement. The effect of the provision is that the transferor gets a deduction of the deferred deduction attributable to the Petroleum Mining Asset in the year the consideration is derived and to the extent of the consideration (not the excess expenditure). The more interesting question which arises, is whether the transferee (farm-in party) can get an immediate deduction for the amount of the consideration, as revenue expenditure; or is the expenditure a capital expenditure; or is it petroleum mining development expenditure which can be deducted in terms of Section 214F? These are difficult questions which cannot easily be resolved.

If the income derived is spread over a number of years then the deductions allowed are spread proportionate to the ratio that the income derived bears to the total assessable consideration in a particular year (Section 214F(4)(c)).

Removal or Restoration Expenditure

Costs incurred in relation to removal or restoration operations (defined term 214D(1)) are deductible in the year they are incurred.

Where a Petroleum Miner incurs a loss in the year in which it either: incurs expenditure, removal or restoration operations; or relinquishes a licence - then such expenditure or deferred deductions which cannot be fully deducted in the loss year can be carried back for previous years (Section 214G).

Assessable Income

The next situations considered are where the Petroleum Miner has assessable income.

Disposal of a Petroleum Mining Asset for Consideration

If a Petroleum Mining Asset is disposed of for consideration the deferred deductions are deductible in the year that the consideration is assessable income to the Petroleum Miner in terms of Section 214H(1); that is, the year in which the consideration is derived.

Associated Person

If the Petroleum Mining Asset has been disposed of to an associated person of the Petroleum Miner, the Petroleum Miner is only entitled to a deduction to the extent of assessable income derived by the Petroleum Miner in that income year. The Petroleum Miner then has to reduce the deferred deductions in respect of the Petroleum Mining Asset by the amount which is not deductible (Section 214F(5)).

If the associated person to the Petroleum Miner subsequently disposes of the Petroleum Mining Asset then that person will be entitled to a deduction of the amount which cannot be deducted by the Petroleum Miner (Section 214F(6)).

It should be noted that 'Associated Persons' are defined in Section 214E more widely than in Section 8 of the Act.

Where an associated person to the Petroleum Miner carries out Petroleum Mining Operation in a Petroleum Miner's licence area for reward and that person is not a Petroleum Miner in respect of those operations the deductions allowed under Section 104 are limited by Section 106F to the consideration received or receivable in any income year which is assessable to the associated person.

The effect of the provision is to prevent an associated person of the Petroleum Miner, which carries out work in respect of the petroleum licence but does not itself have any interest in the licence or the production, creating tax losses.

Subsequent Mining Licence (Section 214F(7) - (9))

Where a subsequent mining licence is issued to replace a licence for an area which contains a sealed and abandoned exploratory well for which the Subsequent Mining Licence Holder has claimed a deferred deduction, special provisions apply in calculating the assessable income of a Subsequent Mining Licence Holder. In the income year a subsequent mining licence is obtained the holder of the licence is deemed to have derived assessable income equal to:

(i) Exploratory well expenditure incurred on exploratory and appraisal well that contributed to defining the extent of petroleum deposits for which the subsequent petroleum mining licence was issued (reduced if applicable, to an amount equal to the proportion the Subsequent Mining Licence Holder's effective percentage interest in the subsequent mining licence bears to the same such interest in the prospecting licence in the income year the deductions were claimed);

(ii) Exploratory well expenditure as described above deducted by a person associated with the subsequent mining licence holder in the income year in which the subsequent mining licence is obtained to the extent of the effective percentage interest held by the subsequent mining licence holder in the subsequent mining licence that was disposed of by the associated person to the subsequent mining licence holder; and

(iii) Interest at the specified interest rate (i.e., the prescribed rate for FBT purposes) calculated from the last day of each income year in which Petroleum Miner deducted exploratory well expenditure, to the last day of the income year in which the subsequent mining licence was obtained, and compounded annually.

The amounts referred to in (i) and (ii) above are treated as petroleum mining development expenditure incurred by the subsequent mining licence holder in the year they are deemed to be derived and are deductible on a deferred deductions basis in terms of Section 214F other than the provision relating to seal and abandonment.

The provisions have limited application and only apply to a subsequent mining licence holder that is a Petroleum Miner or associated person who is the holder of a mining licence which is a replacement licence with respect to the petroleum licence in existence over an area containing a sealed and abandoned exploratory well in respect of which the Petroleum Miner (or associated person) has claimed deductions. Sections 214F(7) to (9) will only apply to the subsequent mining licence holder where petroleum is produced pursuant to a mining licence where the exploratory well has contributed to getting the petroleum.

Proceeds from Disposal of Petroleum Mining Assets

Consideration received upon the disposal of petroleum mining assets is assessable income to the Petroleum Miner in the year the consideration is derived (Section 214H). Deferred deductions attributable to the asset will be deductible in the same year. The consideration provided by the purchaser will be petroleum mining development expenditure incurred in the year of disposition (Section 214H).

The Commissioner has power to disallow deductions where: the person acquiring the licence holds the licence on behalf or for the benefit of the Petroleum Miner or an associated person of the Petroleum Miner; and one of the purposes for such disposal is for the purpose of a tax avoidance arrangement.

Damaged Assets

Consideration (whether insurance or compensation) for damage to licence specific assets is assessable in the year it is derived. Repairs to licence specific assets are deductible in the year the costs are incurred (Section 214J).

Dispositions of Shares or Trust Interests in Controlled Petroleum Mining Entity

Consideration from the disposition of shares in a 'controlled petroleum mining entity' is assessable to the person disposing of the shares or trust interests pursuant to Section 214K. Costs are deductible in the same year. In determining the consideration derived the market value of the interest at 1 October 1990 is used.

Controlled petroleum mining entities are required to furnish information relating to the dispositions in their annual returns.

Farm-out Arrangement

A farm-out arrangement is an arrangement under which a person agrees with a Petroleum Miner to incur expenditure in return for a share in a petroleum licence and the share of the expenditure is greater than the share of the licence transferred.

It is defined in the Act as any arrangement under which a person agrees with a Petroleum Miner to incur excess expenditure. Excess expenditure represents an amount equal to expenditure incurred by a Petroleum Miner in a licence area in excess of its effective percentage interest in the relevant petroleum licence. 'Effective percentage interest' is in essence the lowest of the percentage interest in the petroleum licence, or in proceeds or production which the Petroleum Miner holds or is earning.

It should be noted that 'transferee' in relation to a farm-out arrangement is defined as the person incurring the excess expenditure and 'transferor' in relation to the farm-out arrangement is the person for whose benefit the excess expenditure is paid or provided.

The excess expenditure is not assessable to the transferor but is deductible to the transferee (the farm-in party) either on relinquishment of the licence, disposal or over ten years beginning the first year of commercial production. The transferor must reduce any deferred deductions attributable to the petroleum licence to which the farm-out arrangements relate and to any licence specific assets held for the purpose of conducting petroleum mining operations in respect of the licence.

The deferred deductions must be reduced by an amount which is the lesser of:

- the amount of the excess expenditure; or
- the amount calculated as follows:

$$\frac{a \times c - b}{c}$$

where a = the amount equal to the sum of deferred deductions attributable to the petroleum licence and to any licence specific assets held for the purpose of conducting petroleum mining operations in respect of the petroleum licence;

b = an amount equal to the excess expenditure;

c = an amount equal to the sum of any consideration paid by the transferee which is treated as assessable income to the transferor and the amount equal to the excess expenditure.

The formula will give a zero result in every case except when an up front payment has been made by the transferee to the transferor. This can be illustrated by a simple example.

- (i) ABC Ltd owns a 100% interest in a petroleum exploration licence;
- (ii) ABC Ltd has incurred exploration expenditure of \$2 million up to the current date;
- (iii) ABC Ltd farms out 50% interest in the licence to XYZ Limited in consideration for XYZ Ltd taking on 75% of the cost of an exploration programme.
- (iv) The exploration programme costs \$10 million (\$7.5 million paid by XYZ Ltd and \$2.5 million by ABC Ltd).

Under the arrangement ABC Limited will be required to reduce its deferred deductions by the lesser of:

- \$2.5M (being excess expenditure); or
- An amount calculated by the formula:

$$\frac{a \times c - b}{c}$$

where a = \$4.5M (being the deferred deductions of \$2m already incurred, and \$2.5M incurred by ABC Ltd during the course of the exploration programme);

b = \$2.5M (being excess expenditure);

c = \$2.5M (being the amount equal to the sum of the consideration paid by XYZ Ltd, zero in this case, and the excess expenditure, \$2.5M).

The result of the formula:

$$4.5 \times \frac{(2.5 - 2.5)}{2.5} = 0$$

ABC Ltd must reduce deferred deductions by the lesser of \$2.5M or zero. As the lesser is zero, ABC Ltd will not be required to reduce its deferred deductions account.

Changing the facts a little we now assume XYZ Ltd has agreed to pay an additional lump sum payment of \$1m to ABC Ltd.

Applying the formula:

$$\frac{a \times c - b}{c}$$

a = \$4.5M (as above)

b = \$2.5M (as above)

c = \$3.5M (being the lump sum payment made by XYZ Ltd, being \$1M and the excess expenditure being \$2.5M).

The result:

$$4.5 \times \frac{(3.5 - 2.5)}{3.5} = \$1.29M$$

ABC Ltd must reduce its deferred deductions by the lesser of \$2.5M (the excess expenditure) and the \$1.29M. As the lesser is \$1.29M, ABC Ltd's deferred deductions will be reduced accordingly.

The reduced deferred deductions are then allocated to the petroleum mining licence and to each licence specific asset held for the purpose of conducting petroleum mining operations in respect of the petroleum mining licence in the same proportion that the deferred deductions attributable to the petroleum licence and to each licence specific asset bear to the total deferred deductions attributable to the petroleum licence and the licence specific asset. If excess expenditure is paid in more than one income year the reduction in deferred deductions is spread over the income years in the proportion that the excess expenditure of that income year bears to the total excess expenditure paid or provided in respect of the arrangement.

There is some disadvantage for a transferee to a farm-out arrangement arising out of the current regime. The act of entering a farm-out arrangement does not itself give rise to income to either the transferor or transferee. Excess expenditure is not income to the transferor, but does give rise to a reduction in its deferred deduction if the transferee makes an up-front payment. The transferee is in a similar position to the transferor in all respects, in that the excess expenditure is deductible as a deferred deduction. The transferee is, however, at a disadvantage namely in that it cannot deduct the excess expenditure on seal and abandonment of the well.

Expenditure incurred in drilling exploratory wells under the old regime was deductible in the year it was incurred. Under the current regime it is generally deductible (as petroleum mining development expenditure):

- Over ten years from the date of first commercial production; or
- In full, on the seal and abandonment of the well;
- In full, on the relinquishment (or expiry) of the licence; or
- In full, on the sale of licence pertaining to the area in which the well is drilled.

However, under the current regime where a portion of the expenditure is deemed to be 'excess expenditure' it will not be deductible on 'seal and abandonment' but will only be deductible on commercial production, relinquishment or sale. The balance of the expenditure will be deductible under these provisions as well as on sealing and abandonment.

The extent of the disadvantage to the transferee caused by this regime will depend upon the amount of excess expenditure, the time difference between seal and abandonment and other points of deductibility (sale, relinquishment or production) and the timing of any taxable income derived by the transferee.

Farm-out Arrangements and the Crown Carry

The Crown has a carried interest in each petroleum licence issued in New Zealand of an amount of 11% of each licence issued (the 'Crown Carry'). All participants in a licence will, between them, bear the expenses relating to that 11% (generally borne evenly between them, but subject to any separate agreement which they may make).

Any participant which farms-in to a licence area and accepts its share of the burden of the Crown Carry (in addition to whatever farm-in obligation it has agreed to) will it seem have to treat the Crown Carry as excess expenditure for the rest of its participation in the licence as the expenditure incurred will be in excess of the beneficial interest the farm-in party gets in the licence area.

The disadvantage here would be that the exploratory well expenditure attributable to the transferee's share of the Crown Carry will not be deductible on seal and abandonment but will be accumulated for deduction either on sale of licence, relinquishment or over ten years from the date of first commercial production.

There is a view that a farm-in party taking on the Crown Carry does not constitute a farm-out arrangement. The definition of a farm-out arrangement is an arrangement under which a person agrees to incur excess expenditure. In general terms excess expenditure is expenditure incurred in petroleum mining operations in excess of the percentage of the total expenditure which the Petroleum Miner would be liable to incur in respect of its Effective Percentage Interest (that is the beneficial interest of the Petroleum Miner in the licence area).

Excess expenditure is thus measured as the amount above the effective percentage interest the Petroleum Miner would be liable for. The definition of excess expenditure contains a qualification to the effect that there is excess expenditure only if the Petroleum Miner spending more than its percentage interest receives consideration for so doing in the form of production of petroleum, profits from petroleum or as interest in the licence area, or consideration which is contingent on any of those three items.

The argument, therefore, is that if a Petroleum Miner were to incur a liability for a share of the costs of the petroleum mining operations greater than its Effective Percentage Interest, such additional expenditure is only excess expenditure if the Petroleum Miner in so doing has

agreed to do so in consideration for receiving something in return, which can be described as production, a share of profits from production or an interest in the licence, or which is contingent on any of them. If a Petroleum Miner spends more than its percentage interest share and receives no consideration (as in the situation of the Crown Carry), then such expenditure is not excess expenditure and does not amount to a Farm-Out Arrangement which is caught by the Act.

Disputes

In ascertaining the assessable income of the Petroleum Miner, disagreements can be settled by agreement between the Petroleum Miner and the Commissioner, or by the Commissioner alone or in consultation with the Energy Division of the Ministry of Commerce or other suitably qualified person or organisation (Section 214L).

Petroleum Mining Operations Carried On Outside New Zealand

The regime contained in Section 214D to 214N of the Act applies with all necessary modifications to any Petroleum Miner carrying on petroleum mining operations of substantially the same nature as governed by those sections (Section 214M) outside New Zealand through a branch.

Losses

Losses incurred by a petroleum mining company after 30 September 1990 will be subject to the normal loss carry-forward rules.

The Income Tax Amendment Act (No.5) 1991, provides that from Budget night to 1 April 1992 the 40% continuity of shareholding for loss carry-forward will be determined by the lowest percentage of shareholding based on percentage of voting power or rights to distribution of profits or rights to distribution of capital. From 1 April 1992 a 66% continuity of shareholding will have to be maintained based on the shareholder's interest in the company determined by the lowest percentage voting interest or lowest percentage market value in specified circumstances.

Grouping

From 30 July 1991 companies will only be treated as part of ordinary or specified groups in the 1992-93 year if they satisfy the grouping requirements at all times during the period from Budget night (30 July 1991) to the last day of loss company's income year.

From 1992-93 offsets (rather than subvention payments) will be available to any group without the need for 100% common ownership.

Protected Petroleum Mining Companies

Sections 214O and 214P preserve the Section 214B(9) treatment for further development expenditure incurred by protected petroleum mining companies (that is petroleum mining companies connected with the Maui field).

Losses

Losses incurred wholly or partly by a petroleum mining company in the income year ending 31 March 1991 or any earlier income year, from the deduction of the types of

expenditure on or before 30 September 1990 below are subject to Section 188(9A):

- (i) Exploration expenditure incurred in exploring or searching for petroleum in an area that is subsequently comprised in a mining licence; or
- (ii) Development expenditure in respect of petroleum mining operation or associated petroleum mining operations .

The Commissioner under this provision determines the amount of loss attributable to each licence area - a 'specified sum'. If there is a balance of a specified sum remaining then that may be set off against assessable income derived from petroleum mining by that company from that licence area in any following year irrespective of rules relating to continuity of shareholding.

Grouping

The grouping rules as described above apply.

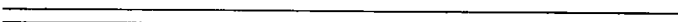
What About the Future?

Given the unlikelihood of changes in the future, the question becomes whether there are any opportunities to accelerate deductions. In relation to petroleum mining development expenditure it would appear the amortisation of that expenditure over ten years from the first year of commercial production will apply.

Other Concerns

It should be noted that Petroleum Miners have other obligations, under the revenue acts. In particular:

- PAYE;
- FBT;
- Income Tax (Withholding Payments) Regulations;
- GST;
- Stamp Duty; and
- Land Tax (which is abolished from 1 April 1992).



Authors

ARCHANA HEDGE is a taxation lawyer presently undertaking contract work for the Inland Revenue Department (Technical Policy Unit). She was previously with Rudd Watts and Stone for two years practising in the area of taxation law.

ROBBIE CULLEN is a lawyer with Rudd Watts and Stone and practises in the areas of taxation and superannuation law, with particular emphasis on tax litigation and on tax structuring. Robbie is a member of the New Zealand Law Society's National Taxation Committee, a member of the International Fiscal Association and a member of the Taxation Institute of Australia.