

MEETING OLD CHALLENGES WITH NEW PERSPECTIVES: ARE YOU READY TO EXPLOIT THE NEW TAXATION REGIME?

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Abstract

The then Minister of Finance, the Hon. R O. Douglas, announced in his budget of 31 July 1986 that the Government intended to withdraw existing income tax concessions available to petroleum mining. Legislation to implement this policy was subsequently introduced, withdrawn, reintroduced, considered by the Finance and Expenditure Select Committee, rewritten following representation from industry, and finally became law, with effect from 1 October 1989. In November 1990, the new Minister of Revenue, the Hon. Wyatt Creech announced the outline of changes to reverse much of the new regime. No timeframe was put on the changes, and nothing specific to the industry has emerged from the last Budget.

It is more relevant to ask therefore, if the new taxation regime is capable, of being exploited, and if so, whether petroleum miners would want to attempt to do so if something better is on the horizon. The paper discusses the industry's reaction to the recent tax changes as expressed through written submissions made to the Finance and Expenditure Select Committee deliberating upon the then Taxation Reform Bill (No. 7). Those submissions are reviewed for content and application to the Income Tax Act 1976, as are the proposals made by Wyatt Creech to see whether they reflect the industry view. Finally, the paper examines how some of the other major oil producing countries tax their domestic oil producers to see if there are any lessons for New Zealand.

Introduction

Over three hundred years ago, a wise Minister of Finance once observed: "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."*

My paper is about bringing a new perspective to this old challenge, and how the hissing of the petroleum mining industry contributes to the realisation of this challenge.

Of course, taxation of the profits of mining petroleum is only one part of the package of measures put in place by government to realise what it considers to be a fair financial return from its ownership rights in the mineral resource.

This package includes the 12.5% wellhead royalty, and the 11% carried interest in every petroleum prospecting licence (PPL), but a full discussion of these two matters lies outside the scope of this paper. My comments will therefore be restricted to the impact on your industry of the Income Tax Act 1976 and its subsequent amendments, which I shall collectively refer to as the Act.

I recently attended a public lecture delivered by Professor Prebble, Professor of Taxation Law at Victoria University, to mark the centenary of the Land and Income Tax Act. He was careful to note that he was not celebrating the centenary; nor was he commemorating the event. He was simply marking it. The title of his lecture asked "Why is Income

Tax Law Incomprehensible". He concluded that this was so because tax law is not based on a foundation of inter-related principle. I suppose you might say therefore that tax law is unprincipled.

It is unprincipled because it attempts to identify the infinite possibilities open to those who seek to avoid the impost without a clear vision of the principles involved. Such an approach is doomed to failure since tax law can only react to the social and business environment not anticipate it. As the environment becomes more complex, so then does tax law. Deregulation has brought with it an explosion in the ways people in this country can make (and lose) money, and with it has come a parallel explosion in the number of words in the Act.

The more words there are to interpret, the less comprehensible the Act becomes. The larger the Act becomes, the more opportunities there are for internal inconsistencies and ambiguities to arise. A considerable contribution to the size of the Act has been made by the attempts of successive governments to use the Act for purposes not directly related to raising tax revenue. The purpose of the Act is to raise money for Parliament to spend. However, past governments have been unable to resist the temptation to use the Act for social and economic engineering purposes, particularly to stimulate or direct economic activity.

*Source: Jean Bapiste Colbert (c 1665)(Finance Minister to Louis XIV).

So it is that tax incentives are perceived as a way of encouraging investment in sectors of the economy considered by the government of the day to be deserving of growth. Farming, horticulture, forestry, films, bloodstock, and of course your own industry have all benefited from this form of targeting at one time or another and during the first ninety years of its existence the Act became cluttered by the debris of successive government's attempts to pick winners. I should perhaps declare myself to be a supporter of the concept of tax neutrality from the outset. The use of tax incentives to subsidise industry sectors is, in my view, a misuse of the Act, and a corruption of the fundamental accountability of governments to Parliament and the electorate at large. Tax incentives reduce the tax impost on particular taxpayers, with the result that all the other taxpayers wind up paying more. The cost of such a subsidy is rarely obvious, being hidden in the general tax rate. The alternative fiscal measure of raising an appropriation in Parliament to pay a subsidy is in my view a much more honest approach, precisely identifies the cost of the subsidy, and results in Parliament revisiting the issue every year the subsidy is paid.

As a bonus, the need to invent elaborate anti-abuse legislation is avoided, and the incomprehensibility of the Act is reduced. This allows me to get on with my job of complying with the Act, and the Inland Revenue Department (IRD) to get on with collecting the revenue.

In his first Budget speech delivered on 8 November 1984, the Hon. R. O. Douglas acknowledged the difficulties arising from the use of the Act for the delivery of economic policy objectives when he said:

"In the past, many policies have deliberately distorted relationships between prices with the result that resources have been encouraged to remain in activities yielding low returns. These policies have come about in response to sectional pressures and an *ad hoc* approach to industry assistance. Over the years, problems have been dealt with through a patchwork of border protection, subsidies, tax incentives and regulations. This reactive approach to industry assistance led to the propping up of some industries which were inefficient and uncompetitive by world standards".

"Assistance levels have varied enormously both among and within industries. Some activities have been given a great deal of help, often for arbitrary reasons. This has disadvantaged other activities. The amount of help given to different activities in the economy must be evened out and reduced. Assistance has become very costly, reducing consumers' income and choice, and increasing government expenditure."

He then set out objectives to guide the proposed process of tax reform:

- (i) To introduce a greater degree of equity into the tax and benefit systems.
- (ii) To minimise the distortions of the taxation system on resource allocation, by reducing anomalies and concessions, widening the tax base and lowering marginal tax rates.
- (iii) To make the tax system more certain and simple.

Now, these sentiments were not new. As far back as 1776 Adam Smith was saying exactly the same thing, but I suppose the perspective is new for New Zealand. From the outset, Douglas insisted that the tax system should be neutral in its effect on business decision making, and the theory was rapidly tested on the farming and horticulture sector. As another significant beneficiary of the system your industry was clearly a prime candidate for reform.

As it happened, nothing more that was relevant to your industry was heard for two years. Then, Douglas announced in his budget of 31 July 1986 that the Government intended to withdraw existing income tax concessions available to petroleum mining. These proposals were subsequently set out in the Consultative Document on Petroleum Mining Taxation dated January 1987 (the Consultative Document). In the preface to the Consultative Document, Douglas noted that the existing incentives were highly concessionary compared with the regime for other business activities. As a result investors were attracted by the tax deductions which could be used to minimise income tax incurred in other activities.

The strong inference was given that this was an undesirable state of affairs, and that expenditure by oil prospectors ought to be treated in the same way for tax purposes as expenditure by other businesses. The Consultative Document urged a move to a more "neutral income tax treatment for petroleum exploration and development by extending to those activities the normal income tax rules applying under the Income Tax Act 1976" (the Act).

In spite of my earlier confession of support for neutrality, I believe that the philosophy underlying these sentiments was misplaced for two reasons. First, the doctrine of tax neutrality is best applied to a closed economy where people in business make rational investment decisions between competing alternative sectors of the economy. This is clearly not the case with your industry which attracts the great majority of its risk capital from offshore. The after tax return on a project in New Zealand must therefore compete with that from projects in other countries if it is to proceed.

Second, the Document implied the existence of some form of benchmark within the Act against which the tax treatment of the industry could be measured. The use of the expression "normal" suggests that the petroleum mining tax regime was abnormal, and therefore had to be changed. The old regime was generous in its assistance to new exploration, and extraordinarily generous in its assistance to the participants in the Maui field joint venture, but frequently there was a sound tax reason for the provisions. If it had a weakness, it was that it was particularly susceptible to aggressive tax planning techniques, but even so, that must have been recognised as a risk at the time the legislation was framed, and discounted in the interests of the larger objective.

What are these "normal" taxation rules which the Document wants to apply to the Petroleum Mining Industry. Most tax practitioners commence their analysis of a tax problem by reference to the rules governing residence and source. Professor Prebble identified these as being two of the reasons for the incomprehensibility of the Act. Residence is a problem of geography and national jurisdictions. Each country can tax only its own residents or citizens income. In the absence of a firm resident status, only income with a source inside the jurisdiction can be taxed.

Take residence for example. Your industry is not confined to the geographic boundaries of New Zealand. What is the real residence status of an explorer spending overseas risk capital, employing overseas management skills, using overseas plant and possibly drilling some way offshore. If the well is dry, the operator may have only a fleeting association with this country. If the exploration is carried on through a foreign owned corporation, special rules have to be created to redefine the boundaries of New Zealand to

make the explorer a resident. His well or his rig is defined to be a permanent establishment to bring the operation into the tax net. Existing rules, such as how to deal with PAYE on the wages of short staying nonresidents working on offshore rigs have to be reinterpreted by the IRD and the Courts. International double tax treaties are then imposed on top of existing domestic law.

The international nature of the industry demonstrates the difficulty of trying to apply ordinary or normal rules of residence. Normality is a condition that is created by the circumstances of the moment.

What about source rules? How can we tell whether the income which flows from the efforts of the explorers has a New Zealand source. What if the Maui product were loaded, at sea, onto vessels for refining and sale in Australia? What if the Maui operators chose to base their office and management in Australia, made all their contracts in Australia and deposited their sales into Australian banks? How logical would it be to say that the income earned from the Maui Field had a New Zealand source? The answer is of course that our Act deems it to be so. Once again, normality is defined by the circumstances of the moment. As Professor Prebble put it:

“The rules of source, likewise the rules of residence, cannot ever be wholly comprehensible because they try to impose laws that we have made upon things that exist in nature.”

Nevertheless, if we accept that in political terms expediency defines normality, and that residence and source rules bring all petroleum miners into our tax net, is that net constructed on logical, consistent and predictable principles. Is there some higher rule book that determines how income is to be identified and taxed. In other words, is there a definition of normality, the presence of which will allow deviation to be measured?

The answer is now officially, no. It is fundamental to any taxing statute that there be no doubt in the minds of the taxpayers about what they are being taxed on. It is fundamental to an income tax that the rules for measurement of income are well established. In New Zealand, despite a century of legislative development, the Act is still open to reinterpretation. In September 1990, the Valabh Committee after reviewing the provisions of the Act relating to derivation of income, and the deductibility of expenditure, (the core provisions) concluded:

- They are not properly integrated with each other.
- They are not properly integrated with the rest of the Act.
- They have an uneasy relationship with undefined concepts, particularly with reference to commercial and accountancy practices.

Major surgery was recommended to correct these deficiencies. Since the very core of the Act is flawed, and the working rules of source and residence are contrived to meet the occasion, it is probably over optimistic to assert that there exists a set of “normal” rules against which the taxation of petroleum miners can be measured.

The Old Regime

Profits earned from the business of extracting, distributing and selling oil and gas were taxed at the same rate as those from any other business. No attempt was made to impose a special tax in addition to income tax such as the Petroleum

Revenue Tax in the United Kingdom or the Petroleum Resource Rent Tax in Australia. Losses were subject to the same treatment as those from non-petroleum mining activities, and were able to be carried forward indefinitely for offset against later income, or transferred around within a group of companies for offset against taxable profits from unrelated activities. It was in the calculation of business profits and losses that we saw the application of special rules. The expression “profit” is not defined by the Act and so business profits (which are specifically deemed to be taxable), have to be calculated by taking allowable deductions away from assessable income. Where deductions exceed income, a tax loss occurs. Given the peculiar nature of the petroleum exploration business, there are rarely profits available to be taxed while exploration is taking place. The rules set out in the old regime recognised this, and were specifically put in place to correct deficiencies in the “normal” rules.

For example, by definition a business expense is only deductible for tax purposes if it is incurred in the carrying on of a business for the purpose of gaining or producing assessable income. The difficulty arises in determining exactly when the business commences, and so when any given expense qualifies as a deduction. A company which undertakes a prospecting programme in the hope of finding oil which it will then be able to sell and earn income will not be in a position to start that business until the oil is found and ready to flow. Until that point there is no business, and no deduction under normal rules. Of course, an oil explorer is quite at liberty to argue that its business is actually the drilling of wells, but this argument is not sustainable for tax purposes unless it is earning revenue for the act of drilling.

A Court may accept that an explorer with a track record of success and who has already earned income from the sale of oil or gas, may consider the drilling of subsequent wells to be part of its ongoing business, but how does this help the newcomer, the risk taker who might only have one PPL and who can only drill one or two exploratory wells with only an outside chance of success? “Normal” rules would effectively preclude that explorer from tax relief, since drilling costs are incurred before his business commenced, and so are not deductible. In the United Kingdom they still have this problem, and with the agreement of the UK Revenue get around it by calling the costs of prospecting Scientific Research, for which a deduction is provided by law.

In New Zealand we did not have to resort to such fictions because all exploration expenditure could be deducted as incurred by virtue of the authority in the Act.

Once a well is proved, the field has to be developed. We now run up against the “normal” rules which attempt to allocate expenditure into capital or revenue categories. Our Act denies a deduction for capital expenditure, although it delegates to the discretion of the Commissioner the ability to allow a deduction for depreciation on specific fixed assets. The normal rules would need some manipulation even to obtain depreciation on certain field development expenditure. Again, our Act covered this position by specifically authorising expenditure incurred to develop a field to be written off over five years.

It is of course the period of this write off, not its existence, which offends the doctrine of tax neutrality. Given the massive cash flows required to develop a field, particularly an offshore field, and the constraints on accurately predicting the life of a field, oil explorers are justifiably interested in

minimising their payback period. The need to provide an incentive through the mechanism of what amounts to accelerated depletion procedures is less obvious in this area until we consider that the playing field for the industry extends far beyond the shores of New Zealand. The application of accelerated depreciation or special depletion allowances for tax purposes is widely accepted in other countries and is automatically built into the models used to evaluate comparative rates of return as between projects. Curiously, the developers of the Maui field were able to take deductions immediately for expenditure, not incurred, not even budgeted, but merely "likely" to be incurred.

Taken together, these provisions were probably more generous than most overseas regimes I have seen. They went some way beyond the technical need to accommodate the characteristics of the industry, and even without the Maui B provisions, gave a significant incentive to explorers to favour New Zealand projects over those elsewhere. They certainly attracted venture capital, which resulted in a flurry of exploration activity. They probably reinforced the intentions of the developers of the Maui field to proceed with Maui B. In other words the policy was working. Energy resources were being discovered and exploited. Nevertheless the use of the tax system for this purpose was regarded as inappropriate by the Labour Government and its advisors as demonstrated by the Consultative Document.

The Process of Change

Legislation to implement the policy contained within the Document was subsequently introduced, withdrawn, then reintroduced as the Taxation Reform Bill (No. 7). This Bill was referred to the Finance and Expenditure Select Committee, and on 2 May 1990 the industry had an opportunity to make submissions. The written submissions are held by the Parliamentary Library and may be examined by any interested party prepared to undertake the time for the research. Through the combined resources of Price Waterhouse and Coopers and Lybrand we have accessed the representations made by a number of the larger players, and particularly by your own Industry Association (PEANZ).

The submissions were made on three levels. Firstly, the broader economic issues were addressed, particularly the significance of the petroleum mining industry to the New Zealand economy and the perceived importance for the continued favourable tax treatment to encourage ongoing exploration efforts. Secondly, matters of taxation policy were debated in an effort to identify whether the existing tax regime was in fact concessionary in the context of normal income tax rules. Thirdly, the Bill was dissected clause by clause for drafting errors, and/or points of detail either to avoid ambiguity, or to redirect the thrust of a particular measure to accord with the philosophical stance of the author.

Underlying all the submissions was the presumption that petroleum is essential to the New Zealand economy, therefore the country needs to be as self sufficient as possible. A lack of self sufficiency was perceived to give rise to two problems. Firstly, the geographical isolation of New Zealand creates a significant risk of interruption of supply with the likelihood of consequent economic damage. Secondly, as existing domestic reserves are exhausted the expenditure of increasing amounts of foreign exchange on petroleum imports will have undesirable consequences on the Balance of Payments.

The Industry argued that government through the tax system, should recognise the strategic and economic importance of an assured domestic oil supply. The time scale required for exploration and development of new fields was offered as a reason why immediate steps should be taken by government to encourage new exploration. The point was made that only by the discovery of another Maui field could existing levels of domestic supply be guaranteed into the second decade of the 21st century. Evidence was presented to the select committee by two major oil companies that the poor prospectivity and increasingly unfavourable business climate in New Zealand meant that this country was not attractive to either company when judged against alternative foreign opportunities.

The action urged by the Industry both through PEANZ and individual company submissions, was in the first place for the government to do nothing. They were well satisfied with the existing taxation regime, and argued that the regime proposed in the No. 7 Bill, far from applying normal tax rules to the industry, in fact penalised the industry by tampering with those rules. The logical consequence was perceived to be the discouragement of ongoing exploration activity.

There was however an acceptance that government was determined to create tax neutrality whatever the consequences, and after initially recommending that no change be made to the existing regime, several submissions proceeded to re-work the Bill to minimise the damage to the interests of the Industry, largely by re-interpreting the Consultative Document's proposition that the taxation of petroleum mining be achieved within "normal" income tax rules.

The New Regime

Various changes were made to the Bill, and although the broad policy issues remained unaltered, the compliance mechanism was significantly simplified. The cumbersome cost of field account disappeared and was replaced by a new concept in New Zealand tax law, the deferred deduction. Many of the technical matters raised in submissions were addressed and it finally became law as the Income Tax Amendment Act (No. 2) 1990, receiving the Royal Assent on 1st August 1990, and having effect from 1st October 1990.

What emerged was certainly seen to be less generous than hitherto. Exploration expenditure could now only be deducted once a well proved to be dry. An explorer has to seal and abandon a dry well, and sign a statutory declaration that it would not be reopened, under pain of clawback of those deductions. The costs of wells that came in, forms part of the development cost of a field which is now tax deductible over ten years. Deductions commence in the first year of commercial production, not the first year the field was capable of commencing production as previously was the case for non-remote wells. The Maui B provisions were retained. Consequential amendments were made to the assessability of farm-in proceeds.

It is not the place of this paper to give a detailed exposition of the new regime, and I leave that to my colleagues following. To revert to the title of the paper however, I find it difficult to see anything particularly new or challenging about the regime. It is less generous in the timing of tax deductions for exploration expense, particularly if the well comes in. It doubles the period over which development expenditure can be deducted, and defers the deductibility of

any exploration expenditure associated with a successful well over that ten year period. At least there has been no move to quarantine petroleum mining losses to prevent their offset against non-petroleum income.

There is still a vagueness about some of the language which needs to be addressed, and undoubtedly there is a challenge to be met there. For example, although the deductions available for the cost of drilling dry wells are related to licence areas, the clawback of those deductions in the event that a mining licence is subsequently issued is related to the undefined area. And what if the well is physically sealed and abandoned before year end, but the statutory declaration is not filed with the Inland Revenue Department until after year end. In what year does the deduction fall?

Interestingly, the new regime gives specific legislative sanction to New Zealand resident companies who wish to venture offshore. Previously a deduction was only available for exploration and development expenditures incurred "in New Zealand". Now, if the Commissioner can identify a licensing system in an overseas country similar to our own, he will allow deductions under the new rules for expenditure in that country.

And so the questions arise one by one as we practitioners try to make real life situations fit the words of the Act. But that is not a new experience. Most new tax legislation is like that. The very first Income Tax Act a century ago needed significant amendment before it was a year old when it was realised that the drafting was so poor that it failed to catch most of the income it was aimed at.

The challenge posed by the new regime is really unaltered from the old, namely maximising deductions at the earliest opportunity, and the identification of assessable income against which those deductions may be applied. For many explorers this will involve finding ways to use losses incurred on abandoned projects, a task now rendered more difficult by the new treatment of dividends imposed by the last budget. Careful structuring of corporate entities will still be required to maximise the benefit of the group loss offset, and loss carry forward provisions of the Act. The timing of exploration activity early in the tax year to allow sealing and abandonment in the same year may be an option, as may be the use of companies with unusual balance dates, or changed balance dates to achieve this objective.

The Future Regime

In 1990 the Government changed. The National Party had previously announced the intention to rewrite the rules relating to taxation of petroleum mining, and in a speech to the annual meeting of PEANZ in November 1990, the new Minister of Revenue, the Hon. Wyatt Creech announced the outline of those proposed changes. Unfortunately he was not prepared to put a time-frame on the changes, other than the period of the Parliamentary term. In his speech, Wyatt Creech stated:

"The previous administration's petroleum mining tax policy failed to recognise the highly risky nature of petroleum mining investment. It also ignored the fact that, while the revenue accruing to the government might be unchanged by what was being proposed, the impact on people making investments in the petroleum mining industry of changing the timing of taxation and deductions could be disastrous. We can no longer simply ignore the behavioural response of taxpayers to our policies."

"To ensure continuing exploration and development of New Zealand's natural petroleum resource, National will:

- (i) Cancel the "cost of licence" system for petroleum mining and allow full deductibility for exploration expenses in the year incurred.
- (ii) Allow development expenses to be written off in a manner consistent with other sectors.
- (iii) Review farm-out arrangements to achieve a neutral tax effect."

"Clearly the government's effort in this area is intended to establish an appropriate tax environment to enable ongoing exploration and development of hydrocarbon fields. In our view our policy will bring tax treatment for petroleum mining more into line with both international practice and the tax treatment of other sectors of the economy."

"What the previous administration's extremely theoretical petroleum mining policy overlooked was the highly risky nature of the sector, which, in terms of its lumpiness of investment in discovery, is more like research and development than any other specific sector."

"The theory was also impervious to issues such as the fact that the adjustments to timing would not add any revenue at all to government coffers and would deter investment. Special national interest concerns such as long term energy security were also considered utterly irrelevant."

"We want to see the trend towards lower levels of self-sufficiency reversed, both for economic and energy security reasons. A principle factor in achieving that goal is the introduction of our petroleum mining taxation regime".

"Greater certainty and stability on the taxation front will enhance the prospects for investment and self-sufficiency".

These comments reflect National Party election policy, and represent a departure from the doctrine of neutrality. They sent a clear signal to the Industry that the use of the tax system to deliver economic benefits to industry sectors was once again in fashion.

Whilst the petroleum mining industry may have been heartened by his comments at the time, nothing has been done to put them into effect. There was no reference to petroleum mining in the last budget and as we have all been painfully reminded, the priorities of new governments have a habit of changing rather rapidly once the first flush of office wears off.

Debate continues behind the scenes however, and I understand that active steps are being taken to develop a cost-benefit analysis of the new regime. One has to applaud such an initiative which hopefully will provide the policy makers with some hard facts upon which future decisions may be based. After all there is little point in government pursuing a policy of tax neutrality if there is no measurable indicator of the success of that policy. Treasury, the Ministry of Commerce, and the IRD are therefore working through the numbers. However, given the volume of tax legislation on other issues that is emerging from the Budget proposals, I cannot see any movement on petroleum mining this side of the new year.

In the meantime the emphasis is clearly now on the protection of the existing tax base. Any reforms which occur from now on will in my view be directed primarily at the continued closure of what we call planning opportunities, and which the more cynical of you may call loopholes. At the very least the industry will see the maintenance of the status quo, unless government can be persuaded that no loss of

revenue will occur from giving a concession. The only exception will be where government perceives an immediate revenue loss being compensated for elsewhere in the economy. An example of this may be found in the increase in the subsidy to private schools to discourage them from exercising their right to integrate into the state system, which would ultimately cost considerably more than the immediate assistance.

If the industry is to progress, their desire for accelerated write-off of exploration expenditure, for example, they are going to have to come up with measurable benefits. This may require you to employ your own economists to study the effects on the economy of a run down in self-sufficiency.

You may also have to look elsewhere other than to the tax system for the delivery of government inducements. I referred at the outset to the existence of a package of measures which need to be considered in any debate on reform; and you are well aware that taxation is but just one part of government's three limbs of fiscal control: It was well publicised by the last Government during the debate on the Resource Management Bill that a whole range of methods of collecting resource rental were under review. The Crown Minerals Act which emerged from the body of that Bill contains no such regime, and simply authorises the Minister of Energy to include in a permit a condition requiring payments to the Crown for both the rights given by the permit and any minerals obtained by the permit holder under the permit. Presumably the matter is still under review. I imagine the industry will not be slow to make their views known to government when a conclusion is reached, and those views will be better received if they are packaged, priced and balanced with the outstanding tax issues.

With the continued recession seriously affecting Government's revenue from income tax, and the apparent determination of the present Minister of Finance to avoid an increase in the rate of tax, there is also real pressure on the IRD to use the existing rules to collect more revenue from the same taxpayers. Considerably more resources are being directed by the IRD into specialist areas of investigation in the corporate sector, and the power of the IRD to reopen returns up to four years old is being fully utilised.

The old tax rules certainly played a part in encouraging exploration. However they also attracted the attention of tax planners who spotted an opportunity to use the system to exploit the tax base. By carefully structuring participation arrangements, often with the use of non-recourse lending, and the use of the group loss offset provisions of the Act, operators found that the total cost of drilling unsuccessful wells could be paid for by the taxpayer.

These practices are now the subject of high level investigation by the IRD. To revert to my opening feathered analogy, some investors are now finding their tax chickens coming home to roost. With the pressure on to collect more tax from its existing taxpayers, the IRD is seriously questioning whether the prices paid by investors wanting to participate in exploration programmes, was commercially justifiable. If the answer to that question is found to be no, then much of the costs claimed as licence acquisition costs and therefore deductible as exploration expenditure will be attacked and disallowed.

An arbitrary rule of thumb appears to have been developed by the IRD to the effect that the value of a petroleum mining licence on the open market should be around twice the

drilling costs. If an investor paid more than this, the IRD allege he was clearly paying for something else, and that "something else" does not fall within the definition of exploration expenditure for purposes of the Act. One of the immediate challenges now facing the industry is the mounting of a defence against these allegations, since there seems little doubt the issue will go to Court.

International Practice

Creech made reference in his speech to bringing the tax treatment of petroleum mining more into line with international practice. In speculating on what this means, it is useful to consider the approach taken elsewhere in the world. To this end I have taken an overview of how some other countries with resident petroleum miners treat:

- (i) Exploration costs of unsuccessful wells.
- (ii) Costs of developing the infrastructure of a proven field.
- (iii) Taxation of the revenues derived from that field.

This consisted of a review of the literature available to me from Price Waterhouse sources, and does not purport to be a comprehensive analysis of world wide trends. Care was taken to distinguish the corporation tax regime, which taxes profits under income tax rules, from the extraction by the State, of its perceived reward as owner of the resource. This latter entitlement takes many forms worldwide and is currently manifested in this country by the royalty imposed on the market value of product.

Australia

Exploration or prospecting expenditure incurred after 18 August 1976 is immediately deductible against income from any source. The deduction in respect of any year is limited to the amount of assessable income after all other deductions (i.e., so as not to create tax losses). Any excess expenditure is carried forward for immediate deduction on the same basis against assessable income of succeeding years. Expenditure carried forward is not subject to any time limits or restrictions concerning continuity of ownership.

Deductions in respect of allowable capital expenditure incurred after 19 July 1982 are available in equal instalments over the lesser of ten years or the life of the petroleum field (or proposed field), on a field by field basis. Deductions in respect of allowable capital expenditure incurred or contracted for on or before 19 July 1982 are available on a diminishing balance basis. The deduction is calculated by dividing the balance of the undeducted capital expenditure by the lesser of the life of the petroleum field (or proposed field) or a statutory period which varies according to the date that the expenditure was incurred.

In the absence of an election to the contrary, tax deductions available in any year are limited to the amount of assessable income after all other deductions. Any excess amounts in respect of post 19 July 1982 expenditure are carried forward and immediately available for deduction in any future year that sufficient assessable income is derived. Excess amounts in respect of pre 19 July 1982 expenditure are accumulated in the residual amount of allowable capital expenditure to be deducted on a diminishing value basis.

An election is also available in respect of both exploration and capital expenditure incurred in the 1985-86 and subsequent taxation years to claim available deductions in full as they arise even though they may give rise to a tax loss.

The advantage of an election to create losses is that the benefit of the deductions can then be transferred to other companies within a wholly-owned corporate group. Once losses have been created in this way they lose their character of allowable capital expenditure and become subject to the rules governing the deductibility of losses. Accordingly, such an election should only be made if the loss is to be immediately transferred. (Australian Mining and Petroleum Taxation.)

United Kingdom

The position is complicated by the existence of two parallel tax systems, the Petroleum Revenue Tax (PRT) and Corporation Tax. PRT ignores the difference between capital and revenue expenditure which is of considerable importance in drawing up accounts on which the corporation tax liability is based. It ignores the usual timing rules used by accounts by not attributing income and expenditure.

The following comments are restricted to Corporation Tax for obtaining a basis for comparison with New Zealand tax practice.

No specific deduction is available in UK law for exploration expenditure. However the UK Revenue authorities agree that the "cost of searching for, discovering and testing new deposits is generally regarded as expenditure on scientific research". Such expenditure, which will include the cost of drilling exploration wells and test and appraisal wells, will qualify as scientific research up to the date when the decision is taken to proceed with commercial production. Expenditure incurred after that date, such as the cost of drilling future appraisal wells and delineation wells, will not qualify for such treatment. The UK Revenue stress that for expenditure to qualify for scientific research allowances it must be directed at producing new knowledge. If no other related trade is being engaged in, the deduction will be deferred until the accounting period in which the decision is taken to develop a field.

There is no equivalent to our "Development Expenditure", or latterly "Petroleum Mining Development Expenditure" in UK corporation tax law. However machinery and plant allowances are given on a wide range of machinery and equipment. The bulk of the expenditure on platforms, pipelines and onshore terminals is likely to qualify for relief under this heading.

Allowances are calculated on a reducing balance basis and a pooling system operates. New qualifying expenditure is added to the pool and allowances given and disposal receipts are deducted from the pool balance. The allowance given for each accounting period is 25% of the pool balance after including all additions and disposal receipts for the period.

In addition, certain costs of searching for, discovery, and testing mineral deposits, and constructing assets whose life is dependent on that of the field, qualify for a "Mineral Election Allowance" being a 25% write down on diminishing value.

The cost of sinking wells to delineate a field after the presence of oil or gas in commercial quantities has been proved, is a revenue expense, and so deductible immediately to particular income years, and is assessed on a field by field basis, without the ability to offset expenditure and losses from one field against profits of others.

Petroleum Revenue Tax assessed is deductible in calculating Corporation Tax.

Profits ensuing from oil and gas exploitation cannot be offset against trading losses incurred in other activities. However, the converse is permissible in that losses from oil and gas exploitation may be offset against profits from other activities. (Sources: *U.K. Taxation on the Profits from North Sea Oil*, Price Waterhouse; *U.K. Taxation of Onshore Oil and Gas*, Price Waterhouse.)

United States

All expenditures incident to and necessary for the drilling of domestic wells, and the preparation of domestic wells for the production of oil and gas, which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property, may either be deducted immediately, or, if so elected, be capitalised and amortised for tax purposes over a 60 month period. If an operator has elected to capitalise, and the well later proves to be non-productive, an immediate tax deduction is available. Dry hole expenses of foreign wells are immediately deductible. Otherwise costs of foreign wells may be capitalised and amortised over ten years, or be subject to normal cost depletion rules which vary from 10% to 21% depending on the type of product, and the type of producer. (Source: *1990 U.S. Master Tax Guide*, Commerce Clearing House.)

Japan

An indirect petroleum tax is imposed on crude petroleum shipped from domestic wells, and on imports, and is earmarked to fund specific programmes to secure a stable supply of petroleum, and to develop and introduce alternative energy sources. Up to 40% of the share capital in, or loans made to an overseas company exclusively engaged in petroleum prospecting, development or extraction may be taken as a tax deduction by the investing company for Japanese Corporation Income Tax purposes.

I could find no specific reference to deductions for exploration and development expenditure. (Source: *An Outline of Japanese Taxes*, Japanese Ministry of Finance.)

Norway

Exploration costs may either be classed as current expenditure or deferred and amortised. Exploration costs include all expenditure incurred prior to an area being declared commercial. If the costs are capitalised the amortisation period is at the discretion of the taxpayer but amortisation must end within five years from the related field coming on stream. Interest on loans used to finance exploration costs may similarly be classed as current expenditure or capitalised. The deduction of interest on inter-company loans is however subject to thin capitalization rules.

Exploitation expenditure must be capitalised and depreciated. The expenditure to be capitalised includes wages of employees in development work and overhead costs. Offshore production assets are depreciated on a straight line basis over a minimum period of six years. The depreciation must be provided in the company's accounts to be allowable for tax purposes. Depreciation commences when the asset comes into use, but from the year of investment for assets acquired after 1 January 1987. The normal rules of the General Tax Act apply to onshore assets which are depreciated on a declining basis at rates from 2% to 30%.

There is no restriction on utilisation of losses from operations on the continental shelf against profits from other activities. However, because the special petroleum tax is assessed on the same basis as income tax, it is usually preferable to carry offshore losses forward. There is a maximum 15 year loss carry forward but the Ministry of Finance has power to extend the period. Losses may be carried backwards for two years if an activity ceases. Only 50% of losses from activities not carried out on the continental shelf may be set off against profits from continental shelf activities. A special petroleum tax, assessed on the same basis as income tax is also imposed. (Source: *European Oil Taxation*, Price Waterhouse.)

Canada

A Royal Commission in 1967 recommended a taxation regime which had many similarities to our own Consultative Document, but this was never fully implemented and Canadian taxation rules have gone through a number of changes since in an effort to balance neutrality with incentive, and to reconcile the competing demands of the provincial and federal governments.

As it currently stands, the income of a taxpayer who carries on the business of exploring or developing or producing minerals, oil or gas is calculated in the same general manner as for other businesses, with the following principal exceptions:

(i) The expenses of exploring or developing a resource property are deductible according to special rules, which rules also provide for the inclusion in income of the proceeds of disposition of resource properties.

(ii) A special deduction in the form of depletion allowance is allowed to taxpayers who have profits from producing resources and have expended moneys within certain time periods to accumulate an earned depletion base. Additional depletion allowances have been available to the oil and gas industry for frontier exploration and for enhanced oil recovery and oil sands projects.

(iii) No deduction is allowed on account of royalties paid to a Government in respect of a resource property.

(iv) Certain of a taxpayer's income from resource properties is eligible for a special deduction at 25% as a resource allowance.

(v) Taxpayers in the mining business are allowed to claim capital cost allowance on certain machinery and equipment at a special, favourable rate. The taxable income of taxpayers in the resource industries is subject to tax at the same rates

which apply to other businesses. (Source: *Canadian Master Tax Guide*, CCH Canadian Limited.)

Conclusion

The principles underlying the new tax regime are roughly comparable with accepted accounting practice, at least to the extent that they deal with exploration expenditure. They are concessionary to the extent that petroleum miners are able to write off development costs over a period that is less than the life of the field. By international standards, however, ten years is probably longer than desirable if we accept the premise that our tax system is a prime mover in the investment decision making process, and the lack of immediate deductibility of exploration expense is also a considerable problem in that context.

Your industry finds its tax regime in limbo, somewhere between the level playing field of Douglas and the new realities of Creech. You have been promised something better, but nothing has yet been delivered. At least you still have a playing field. The superannuation industry has found its playing field dug up in anticipation of being resurfaced, but the contractor went philosophically bankrupt half way through the job when he couldn't find the normal rules of taxation he was supposed to be using, and now no-one can play on it.

The intention of the Labour Government to provide a neutral tax regime which would not distort investment patterns has not worked. To the contrary, since incentives are the norm elsewhere, investment patterns within the industry must inevitably have become distorted as a consequence of the change.

Your industry is under no illusions about what you want, and that largely relates to an acceleration of deductibility over that provided for in the new regime. Your real challenge is to show Government the hard evidence that it is in the country's interest for them to concede this. Remember the subsidy to private schools. Government has to be convinced that a massive increase in imports of petroleum will have measurable effects on the balance of payments deficit, foreign borrowings, and the exchange rate. In turn the rate of inflation will undoubtedly be influenced by shortages of other imported goods if oil companies crowd out other importers from the foreign exchange market. At a stroke all the hard work that has gone into the repayment of our overseas debt and bringing inflation under control may be lost. Perhaps the urgency of the issue means that even I could be convinced that the Act has a place in this agenda. After all, it has had plenty of practice.

Author

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