

PETROLEUM TAXATION— WORKING WITH THE NEW REGIME

J G Weston
Coopers & Lybrand

Abstract

There have been four recent events which served to focus the New Zealand oil exploration industry on its tax regime:

- The new tax regime introduced with effect from 1 October 1990.
- Recent finds of oil and gas in commercial quantities.
- The upheaval in oil prices as a result of the invasion of Kuwait.
- The election of a new Government with a significant mandate and a policy of reviewing the new tax regime.

Each of these events has its own tax impact, and just as importantly, they raise issues of how income tax should be accounted for in the financial accounts of petroleum explorers.

Until recently, the income tax regime appeared to be merely one feature of transactions designed to attract investor finance for petroleum exploration ventures. Such transactions were commonly evidenced by tax losses and it was unlikely that too many people contemplated the need to pay income tax on profits.

With some New Zealand explorers now deriving significant revenues from local finds, and having those revenues inflated as a result of the Kuwait situation, they must instead contemplate the payment of tax sooner rather than later. The new tax regime accelerates this process by deferring the deduction of much of the expenditure previously deducted on an upfront basis. This will require greater sophistication by petroleum explorers in their tax affairs.

Added to this is the election promise of the National Government to "cancel the 'cost of licence' system for petroleum mining and full deductibility for exploration expenses in the year incurred". Obviously this will have a big impact if, and when, it is implemented. Our advice to date is that it will not be introduced retrospectively and is unlikely to take effect until sometime in 1991. Therefore, the regime introduced on 1 October 1990 will continue to be effective until the amendments occur. It is clear that transitional provisions at that time will be important. All of the above factors will cause successful petroleum explorers to take a hard look at how they value their exploration assets, how they amortise them against profits, and how they value their current and future tax liabilities.

This paper provides an update of the tax regime and a summary of the important accounting issues likely to be encountered in practice.

Introduction

On 1 October 1991, the New Zealand oil exploration industry will reach the first anniversary of the implementation of its current tax regime. Separate papers deal with the structure of the regime and planning opportunities and pitfalls. The purpose of this paper is to outline some practical aspects of accounting for tax in the financial statements of the explorer.

Four recent events have served to focus the New Zealand oil exploration industry on its tax regime:

- The enactment of the new legislation with effect from 1 October 1990.
- Recent finds of oil and gas in commercial quantities.
- The fluctuations in oil prices as a result of political instability in the Middle East and Eastern Europe.
- The election of a Government with a policy of reviewing the new tax regime.

Also, there is the tax legislation introduced by Government following the release of its 1991 Budget on 30 July 1991. In particular, the rules which enable companies to carry forward

their tax losses for offset against their future income or against income of other group companies are to be significantly tightened.

The New Zealand Society of Accountants has now also released a revised version of its accounting standard SSAP12 "Accounting for Income Tax", which deals (amongst other things) with the question of recognition of future tax benefits and liabilities arising from adjustments made to taxable income in current years. This is of particular relevance where petroleum explorers write-off or amortise their exploration costs in their accounts using a different method than that approved by the Income Tax Act. The ability of a company to recognise the future worth of its tax losses as an asset is particularly dealt with.

The focus of the paper is on New Zealand oil exploration companies, but many of the principles will equally apply to overseas explorers with New Zealand branch operations.

This paper discusses:

- The Role of Financial Accounting
- The Tax Accounting Standard (SSAP12)
- Particular Issues Arising From the New Regime
- Impact of Future Tax Developments

The Role of Financial Accounting

The petroleum exploration industry is to a large degree a cashflow motivated industry. Typically, the value of a company is determined by future prospects for its interests in petroleum prospecting and mining licences rather than on the historical costs of those interests. This means that the historical figures in the company's financial accounts tend to take on less significance than they would if the company was a manufacturer which had spent its money on, say, a factory. The cost of a factory is a fairly good indicator of what it is worth, whereas the costs of finding oil reserves are not a reflection of their worth.

Until recently, the accounts of New Zealand explorers have concentrated on the presentation of expenditure. Revenues were not usually an issue and tax questions were reserved for the filing of tax returns.

With finds of oil and gas in commercial quantities, explorers have had to address how they recognise revenues, how they match accumulated costs against revenues, and how they record any tax cost which arises (or will arise) if the revenues exceed the allowable costs in any particular year.

As the New Zealand industry matures, the pattern of net income recognition will take on more importance in maintaining and increasing investor confidence. The accounting standards of the New Zealand Society of Accountants have the aim of giving credibility to accounts and promoting that confidence.

Some fundamental principles of accounting standards are that they:

- Do not anticipate revenues.
- Acknowledge expenses as they arise.
- Match revenues and expenses against each other to give a true indication of the change in net worth of the company.

One difficulty accountants have is that they are bound by an artificial twelve month time frame for their reporting. Although some industries adapt their activities to the yearly cycle, this is not possible with petroleum exploration, which has significant lead times for collecting information, drilling, and exploitation. This therefore requires accountants to exercise some judgement in the preparation of twelve month accounts. The accounting standards set out rules to assist them.

In petroleum exploration, the method of accounting most commonly used is the successful efforts method. Under that method, all geological and geophysical costs are classed as current expenditure, on the premise that these preliminary expenses merely indicate places where there are potential reserves. They do not necessarily create an asset. Dry hole costs would usually be classed as current expenditure, and the costs of developing proved reserves are amortised. The method of amortisation is usually the units-of-production depletion method.

The successful efforts method tends to best mirror the way in which large companies operate. They drill so many wells and have such a large base of operations that the cost of unsuccessful drilling can reasonably be considered an

ongoing cost of operations. The impact of writing-off the cost of one unsuccessful well does not show up as a significant variation in the company's pattern of earnings.

With smaller operations, the successful efforts method can give rise to significant fluctuations in net accounting income (or losses) between years. For this reason, the full cost method of accounting was developed and tends to be adopted by smaller and newer companies in some countries.

A further accounting convention that is worth mentioning is the entity concept. Not only do the accounts need to define what time period they cover, but they also need to define the entity to which they relate. This may seem obvious when only one company is involved; but is not so obvious when consolidated accounts are prepared for a group of companies. The tax law varies this even further with the concept of the "associated person", which extends the taxable entity beyond the company.

To give some commonality of treatment of the tax expense which is recorded in the financial accounts, the Society of Accountants has issued Statement of Standard Accounting Practice No. 12 (SSAP12) "Accounting for Income Tax". It was issued in June 1991. This standard goes beyond the previous SSAP12 in including discussion of dividend imputation and taxes on foreign earned income, however a significant part of the new standard continues to focus on tax timing differences and tax loss benefits.

The Tax Accounting Standard (SSAP12)

The revised SSAP12 applies to all financial statements for accounting periods commencing after 1 October 1990. Earlier application is encouraged.

The previous standard only applied to companies and other incorporated taxpayers. The new standard now applies to the external financial statements of all taxpaying bodies. This will apply, for example, to trusts and unit trusts but not to entities which do not pay tax, such as partnerships and joint ventures.

Timing Differences

Timing differences occur when income or expenses are reported in the tax return over the life of, say, an exploration project in a different pattern than the explorer uses for its accounts.

SSAP12 recommends that the liability method be used to record the effect of tax timing differences. This means that future tax obligations are revalued at the tax rate which will apply when the tax becomes payable.

The key feature of a timing difference is that over the life of the project, the same total amount of the income and the same total amount of the expenses will be reported in the tax returns and be recorded in the accounts.

The reason timing differences are factored into the amount of tax expense (or tax asset) recorded in the profit and loss account is because the tax paid on taxable income can vary up and down as a proportion of the net accounting income. This means an investor will have problems gauging the effective rate of tax the explorer is likely to pay on its future income and this introduces uncertainty into the investment decision. Timing differences can give rise to:

- A Tax Asset: Income is reported early in the tax return. An expense is deferred for deduction in a later period.

- **A Tax Liability:** Income is recognised later in the tax return. An expense is claimed early for tax purposes.

Tax provided for on timing differences is known as deferred tax.

Under the old petroleum exploration tax law, timing differences were not a major issue. Exploration expenditure was generally written off for tax purposes earlier or at the same time as the expenses were recorded in the profit and loss account for accounting purposes.

This has been changed by the new tax law, with its ten year amortisation basis of deducting expenses. Now it is likely that an expense will be recorded in the profit and loss account before it can be deducted in the tax return.

Therefore tax assets or FITB's (Future Income Tax Benefits) will be created if an explorer writes off exploration expenditure over, say, five years whereas the tax law requires it to be amortised over ten years. Further differences will arise when the units-of-production method of amortisation is compared with the equal annual amortisation for tax.

SSAP12 limits the ability to carry a tax asset in the accounts. It requires virtual certainty that the asset can be converted to future value. This means that the explorer must be able to demonstrate projected future income sufficient to absorb the future tax deduction. The income must also be projected to arise in the right periods to match the deductions.

If deductions and amortisations exceed revenues, a tax loss will arise. The future tax benefit of a tax loss can be recognised as an asset if the explorer can demonstrate with virtual certainty that it can satisfy the tax rules for carrying forward losses and will have sufficient future revenues to match against the tax loss. This is much harder to justify now that losses are no longer able to be quarantined to licence areas if the loss carry forward shareholding continuity rules are breached.

A compensating factor is that a number of New Zealand explorers now have a more predictable revenue stream and this helps remove some of the uncertainty about recognising future tax benefits.

If a future tax benefit does not meet the tests in SSAP, it should be written-off as an expense in the profit and loss account.

Particular Issues Arising from the New Regime

This section of the paper looks at some of the tax accounting questions thrown up by the new regime.

Transitional Rules (Section 214N)

One of the first accounting issues arising from the new regime was how to account for any tax cost or benefit from the transitional rules. Section 214N(1)(b) only taxes any uplift in market value of petroleum mining assets or interests in controlled petroleum mining entities since 1 October 1990. For measurement purposes, the market value is considered to be not less than the accounting book value at 1 October 1990.

This means there was likely to be an adjustment to the tax holding cost of the asset at 1 October 1990, as in most cases the tax cost differed from the accounting book value.

If deferred tax had previously been provided for on any difference between the tax and accounting values, an adjustment to the deferred tax is required. In many cases, deferred tax can be released. This results from the one-way

nature of the test in section 214N(2), which is a "not less than" test.

Amortisation of PMDE (Section 214F)

Section 214F(2) requires petroleum mining development expenditure (PMDE) to be amortised over the ten years commencing with the later of the first year of commercial production and the income year the expenses were incurred. Unamortised amounts can be deducted if a licence is relinquished or if an exploration well is sealed and abandoned.

Compared to the basis of amortisation adopted by most companies, this rule is very conservative and naturally leads to accounting costs of assets being written off earlier than for tax. This forces the explorer to confront the question of whether to recognise the deferred deductions as a tax asset.

Some of the uncertainty is removed if the licence is relinquished and the explorer has previously paid tax. Section 214G allows deferred deductions to be spread back to prior years. In this case, an immediate tax benefit would be realised rather than a future tax benefit.

Expenditure Clawback (Section 214F(7))

A further difficulty in recognising a tax benefit if deferred deductions have been claimed, is the possibility that the explorer (or an associated person) may one day take a new licence interest in the same licence area, resulting in expenditure clawback. This would give rise to a new tax expense plus a compounded interest factor.

The deductions clawed back qualify as PMDE and as it is unlikely that the accounting book value of the asset would be reinstated at the time of clawback, there is the possibility that the PMDE would be a timing difference giving rise to a future tax benefit. This would need to be evaluated at the time of clawback.

Associated Persons (Section 214E)

The technical term for the "associated persons" rules is "disregard for the corporate entity". Although for legal purposes two companies are distinct and are regarded as being at arm's length, the tax rules draw wider boundaries. In particular, section 214F(6) effectively transfers a deductible expense between two related companies when a petroleum mining asset is sold between them at a price less than the deferred deductions (unamortised tax value) relating to that asset.

The question then arises whether any adjustment to the sale price of the asset should be made to recognise that the tax benefit of a timing difference also passes with the asset, because the amount ultimately deductible to the purchaser will exceed the amount paid for it.

If the vendor company is not compensated for the tax effect of the difference, it will have a permanent tax cost based on the difference between the deferred deductions and what it sold the asset for. Equally, the purchaser company will have a permanent tax saving.

If the vendor company is to be compensated, the tax adjustment should be kept separate from the sale price, to avoid the tax amount being included in the consideration for the asset (and thus in assessable income).

A similar issue arises under section 214I where there is "excess expenditure", but in this case the farm-in party is not likely to be an associated person. The effect of the excess expenditure is to transfer tax benefits to the transferee and it is unlikely that there will be any explicit compensation to the

transferor for this. Any future income tax benefits recorded by the transferor should be expensed to the profit and loss account as the excess expenditure is incurred.

Disposition of Shares (Section 214K)

In most companies (other than share traders) a share investment is a capital asset and the movement in its value is not taxable.

To prevent owners of controlled petroleum mining entities selling shares rather than the underlying assets, the new regime taxes sales of the shares. Accordingly, the movements in share values in the financial accounts should be treated as timing differences in the same way as PMDE.

Impact of Future Tax Developments

As already indicated, there are new tax developments which were signalled by Government in the 1991 Budget, some of which await the passing of legislation before they become effective.

Although none of the changes are aimed directly at the petroleum exploration industry alone, they each serve to emphasise how significant the 1990 tax changes were. A brief description follows on:

- The new loss carry forward and loss offset rules.
- Removal of the inter-company dividend exemption from 1 April 1992.
- The new deemed dividend rules for low-interest loans.
- Proposed rules to allow a group of companies to file a consolidated tax return and disregard intra-group transactions.

One change which does not require further comment is the failure of the Government to implement its pre-election policy of reviewing and amending the oil exploration tax regime. To date no details or amending legislation have been released. This increases the element of uncertainty which must be coped with in accounting for income tax, although indications to date have been that legislation would not have retrospective application (i.e., apply from 1 October 1990).

Loss Carry Forward and Loss Offset Rules

Prior to the introduction of the new petroleum exploration tax regime in 1990, there were two exemptions from the tax loss rules normally applying to New Zealand companies:

- (i) Losses arising from petroleum exploration were subject to the normal 40% shareholding continuity rule, but if the rule was breached it was still possible to carry forward the losses against any income arising from the same licence area in future years.
- (ii) Investor companies were able to access losses arising from petroleum exploration in proportion to their contribution to the expenses of the explorer, even if the two companies did not satisfy the usual two-thirds common shareholding required to transfer other types of losses.

These exemptions now only apply to losses which arose from expenditure incurred prior to 1 October 1990. Losses arising from amortisation of PMDE and from deductions on relinquishment, sealing and abandonment, or disposals are now treated as any other tax loss. There is, however, provision to spread back deductions in some cases under section 214G.

From Budget Night (30 July 1991) the loss carry forward rules have been changed to tighten up the 40% shareholding continuity test. Also, from the start of a loss company's

1992-93 tax year the test will change to 66% continuity based on voting power. Where there are non-voting shares or certain types of quasi-equity instruments, the test will become a market valuation test. The 66% level will be measured by the lowest interest held by shareholders from the time the loss arose to the end of the year the loss is used.

Similarly, from Budget Night, losses may be offset between group companies if they have 66% commonality of shareholding from the beginning of the year the loss arose (or Budget Night) to the end of the accounting year in which group offset occurs. This replaces the previous 31 March single day grouping test.

The commercial impact of these changes will be to restrict the ability of explorers to introduce new equity participants to licence interests and will limit the opportunity to use redeemable shares or floating rate debentures to fund future exploration.

From an accounting angle, the new rules increase the likelihood of a loss company breaching the necessary continuity and make it harder to justify carrying forward a deferred tax asset in the financial accounts.

Removal of the Dividend Exemption

Typically, an explorer will set up separate subsidiary companies to hold its different licence interests. This limits its exposure under any joint venture to the capital of the subsidiary and enables equity interests to be offered if it is not possible to farm-out the actual licence interest. This can result in chains of companies under the umbrella of the parent.

Currently, profit-making New Zealand companies can pay dividends to their shareholder New Zealand companies tax-free. From 1 April 1992 this will change, although there is a transitional extension to 1 April 1994 for some redeemable shares.

The position of dividends received from offshore subsidiaries and those paid to offshore shareholders will not change.

The removal of the dividend exemption will be like a capital gains tax. Dividends will only be tax-free if they carry the full allowable ratio of imputation credits. If a dividend is sourced from a non-taxable gain, there will be no imputation credits and the gain will be taxable when it is distributed. This will possibly not be a big concern to petroleum explorers, as the tax regime already has elements of a capital gains tax.

A further problem will occur when a dividend is paid to a loss-making company. If, for example, the shareholder company is in a tax loss position from costs of funding the equity in the subsidiary, the dividend will be offset against its tax losses and will reduce the ability to shelter other income from tax. This will occur even if the dividend carries imputation credits.

This change is fundamental to the way groups of companies have been set up and will require more analysis. Some preliminary thoughts are:

- (i) Pay dividends from distributable reserves (or make a taxable bonus issue) before 1 April 1992.
- (ii) Operate through divisions if subsidiaries are not required.
- (iii) Keep a flat group structure without long chains of companies.
- (iv) Do not keep non-taxable appreciating assets in separate companies unless it is more usual to sell the shares than to sell the assets.

New Deemed Dividend Rules

From 1 April 1992, loans between parent and subsidiary companies will be taxed if the interest rate on the loan is below market rates. If the loan is in New Zealand dollars, the Fringe Benefit Tax (FBT) specified interest rate (currently 12.4 %) will be used. If the loan is in another currency, an arm's length market rate will apply.

Any shortfall in the interest charged will be treated as a dividend (even if the loan is from the parent to a subsidiary). Loans between New Zealand companies will give rise to a quarterly non-deductible FBT liability to the lender.

Cross-border loans will give rise to a non-resident withholding tax or a foreign dividend withholding payment liability to the New Zealand company, depending on whether it is the lender or the borrower. Neither tax will be tax-deductible.

These changes mean that a tax expense will arise even though no income will ever be recorded in the financial accounts of the recipient of the loan benefit. Petroleum explorers should review their group loan funding arrangements to make sure these taxes are not unnecessarily incurred.

Consolidated Tax Returns

One possible way around the taxable dividends and the low-interest loan dividends is the proposal to allow groups of New Zealand companies to file consolidated tax returns. All

transactions within a group of 100% owned companies will be ignored for the tax return and for stamp duty purposes. The legislation has not yet been introduced but the proposal was outlined in detail in the 1991 Budget.

The ability to consolidate (from 1992-93 onwards) will not be without cost and the election to consolidate companies should not be taken lightly. There are tax costs where a company later leaves the consolidation. Some transactions which were earlier ignored become taxable when the company exits. This will make it difficult to sell partial interests in a licence through a sale or issue of shares in the company holding the licence interest if the company is currently consolidated.

The rules will require some duplication of record-keeping so that asset values on any intra-group transactions can be traced in the event that the vendor or purchaser company leave the consolidated group.

If the tracing rules had not been included, it may have been possible for group companies to sell exploration assets between themselves to uplift the cost able to be amortised, without being taxed on the uplift.

The key feature to note in any consideration of using these rules is that each company will be jointly liable for all group tax liabilities which arise while the company is included in the consolidated group. This will be a particular risk to a purchaser if a company which has previously been consolidated is bought.

Author

GRANT WESTON is a tax partner in the national accounting firm Coopers and Lybrand.