Tax efficient business structures for petroleum mining

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Introduction

Over the past three decades there have been significant changes to the taxation treatment of petroleum miners. Prior to 1971, the income derived by petroleum mining companies was not taxable but rather dividends paid by the petroleum miners in excess of 'irrecoverable expenditure' was taxed. Now generally all income is taxable, with an allowance for deductible expenditure but subject to complex rules determining when deductions can be claimed. In addition, from December 2001, income derived from the sale of shares in a controlled petroleum mining entity is no longer taxable. This change in legislation reverses the position taken in 1990 when the legislation was amended to tax proceeds from the sale of shares in a controlled petroleum mining entity.

This paper considers the tax efficiency of various asset owning structures focusing on unincorporated joint ventures with foreign controlled joint venturers. It should be noted at the outset that the most optimal structure is very fact dependent and country specific, therefore specific advice should be obtained before acting upon any of the comments included in this paper.

The analysis in this paper is based on a greenfields investment by two or more non resident parties in a New Zealand petroleum mining venture where no party has a controlling interest. The objective of this paper is to provide income tax specific commentary in relation to the following:

- Should a company or an unincorporated joint venture be used?
- What should the joint venturer be, a company or a branch?
- Is debt funding more tax efficient than equity funding?
- How much debt funding is allowable?
- What is the Foreign Investor Tax Credit ('FITC') Regime?
- Are there any restrictions which apply to utilising tax losses from petroleum mining?
- Are there any benefits in holding each licence interest in a separate company?

Summary

In summary, the optimal structure is dependent upon the specific facts of each situation including the tax profile of the non residents, the tax laws of the home country and interaction with the tax laws of New Zealand and the tax profile of the New Zealand group. It is suggested that non resident petroleum miners who do not have a controlling interest should hold their interests in New Zealand licences via a New Zealand incorporated company which in turn has an interest in an unincorporated joint venture. The joint venture will carry out the mining activities which, for income tax purposes, will be attributed (based on the venturers proportionate interest) to the New Zealand company.

Tax attributes such as tax deductions, losses and credits will either be recognised by the New Zealand company as their own (eg proportion of expenditure incurred by the joint venture will be attributed to the company) or arise within the New Zealand company (eg tax payments, will generate imputation credits in the New Zealand company). As a consequence, the tax attributes are immediately accessible (ie not ring fenced in the joint venture) and the risk of forfeiture due to activities of other venturers is eliminated.

From a New Zealand perspective, debt funding is more tax efficient as interest (subject to thin capitalisation and transfer pricing rules) is generally tax deductible and attracts a lower level of withholding tax[1] as compared to dividends which are not tax deductible. It should be noted that to satisfy the thin capitalisation rules, the New Zealand group must have an asset base (ie debt to total assets can not exceed the greater of 75% and 110% of the world wide group debt percentage). As a result, new foreign entrants into the New Zealand exploration industry who debt fund their operation are likely to have interest deductions disallowed because they are unlikely to have a significant asset base until recoverable reserves have been identified. Funding of exploration activity for these entities may need to be interest free or via equity.

As the outcomes from a group perspective are dependent upon the tax profile of the parent company and its home jurisdiction, it is recommended that projections (cash and taxable income) of the New Zealand venture be prepared to assist the formulation of a tax effective and flexible investment/divestment and funding structure.

[1] The withholding tax can be reduced to nil and a 2% Approved Issuer Levy paid where the lender is not associated with the borrower.

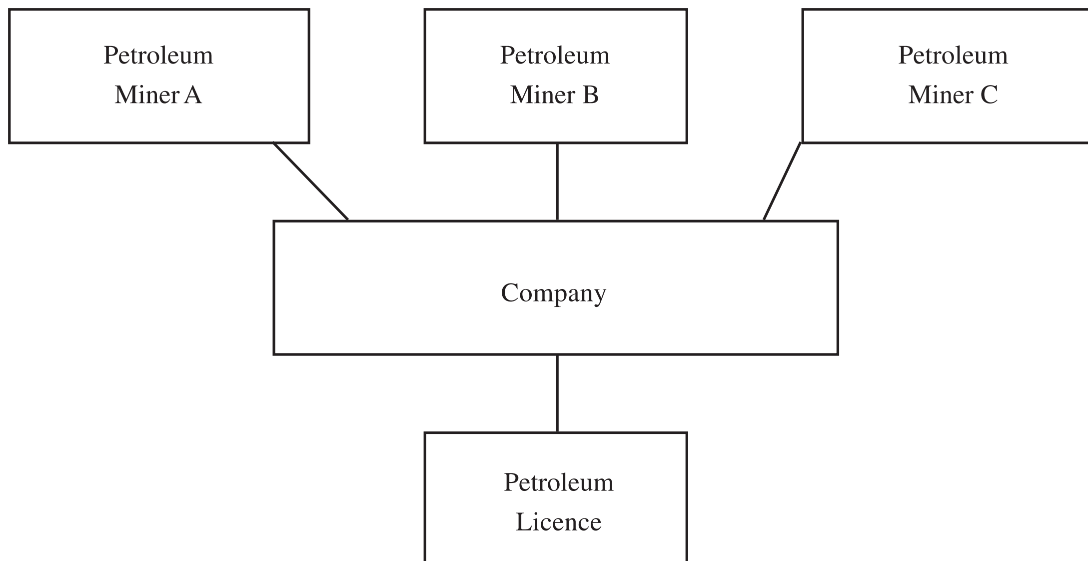
Company vs. unincorporated joint venture

Determining the legal vehicle which is to be adopted is critical for ensuring that the stakeholders get the maximum benefit for the least amount of risk.

A limited liability company could be used to own the full interest in the licence area. The stakeholders would obtain their interest in the licence by owning shares in the company based on proportions required to give the desired interest in the licence. The following diagram illustrates a simple company structure with the petroleum miners obtaining an interest in a licence via shares in a company.

A further consequence is that a company can only carry forward its tax losses if its shareholder continuity percentage is at least 49% from the date the losses are incurred to the date they are utilised. Accordingly, any change in the shareholding of the company will have a negative impact on the ability of the company to carry forward its tax losses. For example, if Petroleum Miner A and B sold their respective shareholding in the company to Petroleum Miner C, all tax losses incurred prior to and not yet utilised at the time of sale would be forfeited resulting in an overall value loss.

The tax losses are also vulnerable to any change in the shareholding of the petroleum miners. Such changes will be completely outside of the control of the other shareholders.



Key tax issues which arise from this structure include:

- access and security of tax losses
- accessibility of cash surpluses
- security of imputation and other tax credits generated by the company.

Invariably a petroleum mining operation will comprise a significant lead-in period whereby significant expenditure is incurred in the exploration and development of a licence area.

Even in cases where commercial levels of recoverable reserves are identified, the tax profile will generally comprise an upfront period of expenditure followed by taxable revenues during production and finally further expenditure for the restoration of the site.

Using this company structure will mean that the deductible expenditure will be trapped in the company and is of no benefit to the shareholders until such time that the company generates taxable income. This is because a shareholder can not utilise a company's tax losses unless it has a 66% or greater shareholding in the company over the period which the tax loss was incurred to the end of the year in which the tax losses are utilised.

In some cases detailed provisions could be included in shareholder agreements to minimise this risk, however restrictions on share transfers (especially the shareholding of a non related company) is not likely to be acceptable to the parties involved.

Other tax credits which are also subject to specified minimum shareholder continuity percentages, such as imputation credits will also be at risk. Although the vulnerably of imputation credits can generally be eliminated by making timely distributions, this may not be an ideal outcome.

In cases where the venture is not successful, the tax losses will be locked within the company and of little value to the shareholders unless the company generates future taxable income to absorb the tax losses. In addition a further agreement amongst the shareholders to maintain 49% shareholder continuity would be preferred so that the tax losses continue to be available to the company over the relevant period.

A further issue which arises from the company structure is the ability to access positive cash flows when the company is incurring tax losses or utilising past period tax losses. Generally a distribution to a shareholder will be a taxable

dividend if derived by a New Zealand resident shareholder[2] (subject to resident withholding tax) or subject to non resident withholding tax ('NRWT') for a non resident[3].

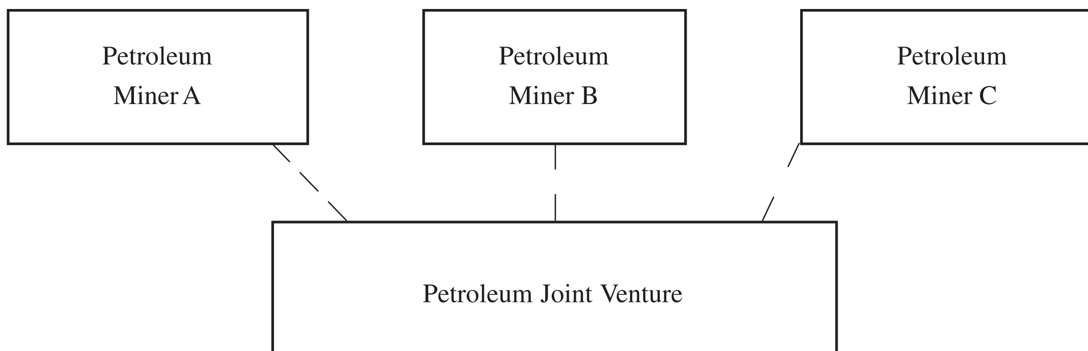
While this could be overcome by using interest free debt funding which could be repaid upon positive cash flows or even repurchasing capital, potential issues such as transfer pricing for the non resident lender on the interest free debt (for non resident shareholders) and ensuring that the capital repurchased does not fall foul of the dividend rules must also be overcome.

In contrast to the above an unincorporated joint venture overcomes the tax disadvantages mainly because it is not recognised as a taxpayer for income tax purposes[4]. Each joint venturer is taxable on its proportionate share of the gross income and deductible expenditure.

period which shareholder continuity must be maintained and therefore reduces the risk of forfeiture.

Consistent with tax losses, tax credits such as imputation credits are also more secure and manageable as they are held by a group company rather than by a company which other shareholders may have a greater level of control.

Cash injections and distributions between a joint venturer and the joint venture are not recognised for income tax purposes[6]. These are analogous to transactions between divisions of a company. Accordingly, cash surpluses can be distributed to the joint ventures without the same restrictions that apply to companies (ie, imputation credits are not required to make tax free distributions).



Tax losses arising from the joint venturer's interest flow directly to the joint venturer and can either be used to offset other taxable income derived directly by the joint venturer or a company/branch in the same New Zealand group as the joint venturer. Surplus tax losses can be carried forward by the joint venturer to subsequent years and subject to the shareholder continuity and commonality tests being satisfied, be offset against future taxable income derived by the joint venturer or group company respectively. Hence under the unincorporated joint venture structure, tax losses are accessible to joint venturers immediately.

The risk of forfeiting tax losses is also significantly reduced because:

- The shareholder continuity tests are in respect of the joint venturer's shareholders only and not the shareholders of all of the joint venturers.
- The tax losses are accessible immediately for offset against non joint venture specific taxable income where as the company structure[5] effectively eliminates the ability of the tax losses to be used against taxable income other than that generated by the company. In addition, utilising tax losses earlier reduces the time

Resident vs. non resident holding company

Non resident petroleum miners generally operate in New Zealand via a branch of an offshore company or incorporate a new/use an existing New Zealand company.

The following tax issues should be taken into consideration when determining the pros and cons of using a branch or subsidiary:

- Restrictions on cash distributions from New Zealand.
- Home country tax issues.
- Ability to utilise tax losses.

Generally, the rules applicable for determining the taxable income of a branch and a company are the same. For example, the tax rate for both is 33% and the tax basis for recognising income and expenditure under the Petroleum Mining Tax Regime is the same.

However, New Zealand tax will only apply to a branch's New Zealand sourced income, whereas a company will be liable to New Zealand tax on its New Zealand and worldwide

[2] The dividend will be exempt from income tax and not subject to resident withholding tax ('RWT') if the shareholder is a New Zealand resident company and owns 100% of the company paying the dividend. In addition no RWT will apply if the dividend is fully imputed.

[3] This can be minimised by using the FITC Regime (refer later discussion).

[4] An unincorporated joint venture is not required to file a tax return.

[5] Company tax losses can only be offset if the shareholders has a 66% or greater shareholding in the company.

[6] Transactions between a venturer and the joint venture are recognised for Goods and Services Tax.

income. This distinction will have little impact if the operations are limited to New Zealand.

Cash distributions between a branch and its parent are not taxable transactions as they are between the same legal entity. In contrast, cash distributions between a company and its non resident shareholder will generally be treated as a taxable dividend and attracts non resident withholding tax at the rate of 30%[7] resulting in an additional cost when compared with a branch.

A company can eliminate the additional NRWT cost by utilising New Zealand's FITC Regime. An objective of this regime is to reduce the New Zealand tax impost on the companies earnings to the same as what would be imposed if the shareholder was a New Zealand tax resident company (ie 33%). To take advantage of this regime, the company must be able to fully impute the dividend[8].

However, companies may not have sufficient imputation credits to fully impute distributions due to differences between accounting and tax treatment of income and expenditure, for example accelerated tax deductions arising from the amortisation of capital expenditure. Hence dividends may be possible but no imputation credits available. Accordingly, where insufficient imputation credits are available the branch structure should result in less New Zealand tax being imposed.

Home country tax issues which should be considered include the following:

- Will the taxable income derived by the New Zealand branch also be subject to tax in the home country? If yes:
  - Will this result in double taxation or will the home country recognise New Zealand tax paid/payable as a reduction against home country tax?
  - Is the home country tax rate greater than the New Zealand tax rate so that further tax will be payable notwithstanding a credit for New Zealand tax paid.
  - Is the tax treatment in the home country and New Zealand so different that there is a risk of tax being paid twice on the same income? For example, if the home country tax regime is more favourable such that the timing of the deductions is accelerated relative to New Zealand, tax payments in New Zealand will exceed the tax payable in the home country in the early years. As the New Zealand tax paid which exceeds the tax payable in the home country generally can not be carried forward to meet future home country tax obligations (which will be greater in the later years as less tax deductions are available relative to New Zealand), double taxation can result.
- Will the home country recognise tax losses incurred by a branch, thereby allowing earlier utilisation of the tax losses in two jurisdictions. The utilisation of the tax losses in the home country should not affect the ability or the quantum of tax losses utilised or carried forward for New Zealand tax purposes.

The tax loss carry forward and group loss offset rules generally apply to both companies and branches in the same way. For a branch, it is the shareholding of the head office which comes under scrutiny. In summary, a tax loss incurred by a branch/company can be carried forward and offset against future taxable income generated by the branch/company provided it maintains 49% shareholder continuity from the date the loss was incurred to the date it is utilised.

Branch losses can be offset against other New Zealand group company's taxable income provided the 66% shareholder commonality test is satisfied. However, for a branch, there is an additional requirement that it carries on a business continuously throughout the measurement period where as a company can cease its business activities in New Zealand (ie dormant company) without jeopardising its tax losses. There is no requirement for the business of the branch to be the same business to satisfy the continuity of business test.

Although companies are able to cease their business activities without forfeiting their tax losses, they must ensure that they are not dual resident[9], if they wish to offset their tax losses to New Zealand group companies. If the loss company is a dual resident then the tax losses are ring fenced and can only be used to offset its own future taxable income. This can result in the expensive position of a group company paying tax for the same income year that a dual resident group company is incurring and carrying forward tax losses.

It is quite possible that new subsidiaries incorporated in New Zealand with offshore parents will be dual resident companies because of the significant level of offshore control and day to day management required. This maybe due to the time it takes to get the New Zealand infrastructure set up or

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[7] The rate of NRWT is generally reduced to 15% if the shareholder is a resident of a country which has entered into a DTA with New Zealand or if the dividend is fully imputed. Refer www.pwc.com for a full list of countries which New Zealand has entered into DTAs and their respective withholding tax rates.

[8] A smaller reduction can be obtained when the dividend is partially imputed.

[9] A dual resident company, is a company that is:
(a) Resident in New Zealand; and
(b) Either-
(i) Treated under a Double Tax Agreement ('DTA'), as not being resident in New Zealand for the purposes of the DTA; or
(ii) Also by the law of another country or territory, liable to income tax in that country or territory by reason of domicile, residence, or place of incorporation.

alternatively a more conservative approach being adopted to the New Zealand venture (ie control/operate the business from offshore until it is clear that it can stand on its own and worthy of its own infrastructure).

Being a dual resident company may also be advantageous as it may allow the offshore parent company (subject to the specific tax law applying to the parent company) access to tax deductions in its home jurisdiction for expenditure incurred by the New Zealand company. For example, a successful international group with no current taxable income in New Zealand may be able to access immediate tax benefits for the expenses incurred rather than carrying forward the tax benefits to a future date when/if taxable income is generated in New Zealand.

Funding

Generally, foreign shareholders prefer to debt fund (using available funds within the international group) their New Zealand operations because interest is normally tax deductible where as dividends paid on equity funding are not. The home country will generally include interest as taxable income and depending upon the relative income tax rates there may be an advantage or further cost to the group. Notwithstanding the potential arbitrage, debt funding should result in the tax impost shifting to the home country which may be beneficial as tax paid in the home country may be passed out in the form of the tax credits to shareholders thereby reducing the risk of further tax being payable at the shareholder level.

The level of deductible debt funding which can be used by New Zealand companies and branches with offshore ownership is capped by New Zealand's Thin Capitalisation Regime. The objective of this regime is to deter non residents from gearing their New Zealand operations with a disproportionately high level of debt relative to their international operations. For the purposes of determining what is debt there is no distinction between local or foreign debt or whether the lender is associated with the borrower.

The New Zealand regime operates by disallowing a tax deduction for interest on debt which exceeds 110% of the companys world wide group debt percentage. Put another way, the New Zealand group of companies can be debt funded to a level which is 10% greater than the level of gearing adopted for the international group. Interest on debt in excess of this level is not deductible.

A 75% deminimis level has also been legislated to simplify the calculations. Accordingly if the New Zealand group debt percentage is 75% or less then the thin capitalisation rules will not deny a tax deduction for interest incurred.

An important point to note is that the New Zealand group debt percentage is based on the total assets of the New Zealand group. Total assets are required to be calculated in accordance with generally accepted accounting practice. As a result, start-up operations in New Zealand which incur significant expenditure which can not be capitalised (eg exploration expenditure prior to recoverable reserves being identified) are precluded from claiming an interest deduction in respect of any debt funding to the extent of that expenditure.

Interest paid to non residents (including interest which is treated for New Zealand income tax purposes as non deductible) will attract New Zealand NRWT at a rate of 15%. If the lender is resident in a country which New Zealand has a Double Tax Agreement ('DTA'), then this rate is generally reduced to 10%. However in some cases the DTA does not provide any relief. For example, the New Zealand/Singapore DTA does not reduce the rate of NRWT where the borrower and lender are associated parties. As a result, the Singaporean related lender is required to file a New Zealand income tax return. Its tax liability is the greater of 33% of its taxable income (being the New Zealand sourced income less any expenses incurred in generating that income) and the 15% withholding tax paid at the time the interest was paid.

Interest paid by a New Zealand branch to its head office prima facie, does not attract NRWT on the basis that payments made between the same entity are not recognised for New Zealand tax purposes. However, where the 'internal loan' is clearly funded by an external loan, then arguably the payments made on the external loan attract New Zealand NRWT.

Dividends paid by the head office of the New Zealand branch are in practice not recognised as a transaction within the New Zealand tax net and therefore do not attract NRWT. Dividends paid by a company in New Zealand attract NRWT and have been discussed above.

Exit strategies

In many instances an exit strategy is not factored into the appropriateness of an investment structure. There are many reasons for this approach including time and cost constraints, uncertainty about the future profitability, and uncertainty about the legal framework and tax laws which will be applicable at that time.

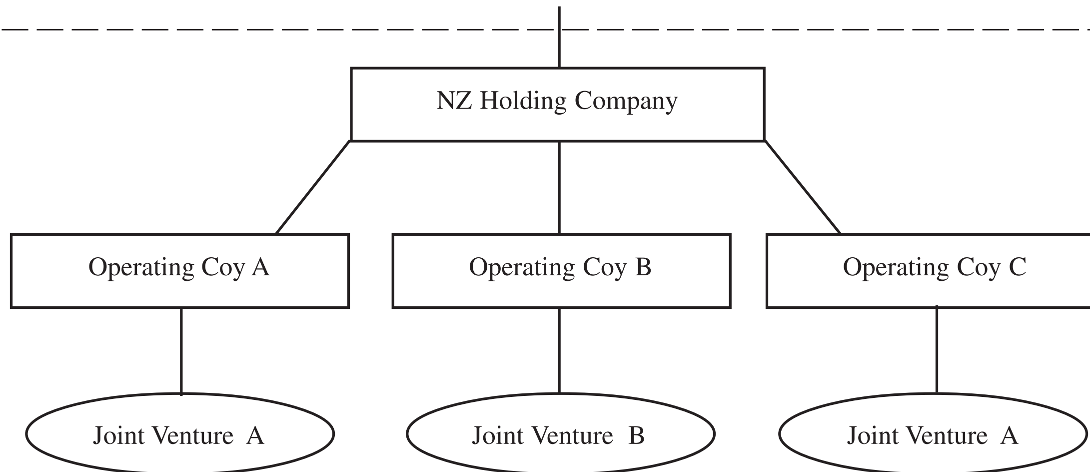
In this regard any the structure adopted should have the flexibility to cope with what is known now whilst allowing for potential changes in the future. From December 2001 the proceeds from the sale of shares in a controlled petroleum mining entity ('CPME')[10] are no longer gross income. Similarly, the cost of shares in a CPME which are disposed after December 2001 is non deductible.

[10] A CPME is a company or trust that is a petroleum miner and 90% or more of its value is owned directly or indirectly by five or fewer persons and whose market value of petroleum mining assets exceeds 75% of its net assets as set forth in its accounts prepared in accordance with generally accepted accounting practice.

In contrast, if the underlying petroleum mining assets were sold, the resulting gain/loss will be taxable/deductible. Accordingly, to maintain flexibility it is suggested that a company should be used rather than a branch and thereby allowing future sales to occur as a share or asset sale. The branch structure only allows an asset sale unless all the international activities of the head office are also to be sold.

Further flexibility could be achieved by using a separate holding company for each petroleum mining asset as shown below:

Dividends paid between companies which are 100% commonly owned New Zealand resident companies are exempt from income tax. Accordingly, cash positive companies (which may not be paying any tax due to tax depreciation) are able to pay dividends to the holding company without attracting any tax. The New Zealand holding company can then inject the funds into the cash negative companies, or use existing imputation credits from other companies to repatriate the income offshore.



This structure would provide, for future divestments to be either asset or share sales depending on the purchaser's tax profile. For example, a purchaser may have significant tax losses and therefore is not concerned by the relatively lower tax depreciable base that may arise from a share sale.

All the companies are part of a 100% wholly owned group therefore tax losses arising from the interest on Joint Venture A could be offset against taxable income derived from the interest in Joint Venture B[11].

Equity funding could be passed down the chain as could debt funding. Alternatively, the debt funding could be direct to the operating companies from a local or offshore group finance company.

The inclusion of a New Zealand holding company is optional and primarily to facilitate the transfer of funds from New Zealand cash positive companies to cash negative companies without the need to:

- repatriate funds offshore and invest back into New Zealand (resulting in a withholding tax cost); or
- complicate the structure with loans between operating companies.

In addition to the above, consideration should be given to identifying further enhancements. For example:

- Using a hybrid security which is treated differently in the two jurisdictions involved thus resulting in a tax deduction by the payer and no taxable income for the recipient
- Reducing/eliminating the withholding tax payable on interest.
- Claiming interest deductions in two jurisdictions.

The ability to apply any of the above is very fact dependent and requires careful analysis of the laws (including the anti-avoidance provisions) applying to each jurisdiction.

[11] Minimum level of shareholder commonality for tax loss offset purposes is 66%. In addition there is no requirement to combine the shareholding of the various companies under one New Zealand holding company. The shareholder commonality test does not distinguish between different countries or locations of residence.

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VINCENT SUE is a Partner in the Taxation Services Division based in Wellington. Vincent has over 14 years of experience in providing tax consultancy services to a range of corporates involving assignments in tax advisory, tax compliance and audit. He has significant experience in the oil and gas, banking/funds management, and electricity industries. A key area which Vincent focuses on is the management of tax risk to ensure that the tax does not destroy value. For further information contact Vincent Sue phone: (04) 462-7332, email: vincent.sue@nz.pwc.com) or visit our website: www.pwc.com.